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State and Local
Finance
in the
National Economy

BOOKS BY ALVIN H HANSEN

FULL RECOVERY OR STAGNATION?
FISCAL POLICY AND BUSINESS CYCLES

with HARVEY S PERLOFF
STATE AND LOCAL FINANCE IN
THE NATIONAL ECONOMY

State and Local Finance *in the* National Economy

By

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First Edition



A WARTIME BOOK

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MENT'S REGULATIONS FOR CONSERVING
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INTRODUCTION

IN THESE war years we have rediscovered our economic power. Throughout the thirties, the strength of the American industrial giant lay dormant. No one in 1940 dreamed that the Federal Reserve Index would reach 240 in 1943; that the Gross National Product would reach \$187 billion; that the national income would reach \$148 billion. These things were just not believed possible. But here they are. Our productive capacity has reached a level so high that if we now permitted our national income to fall to the level of 1929, we should have about 18 million unemployed.

Thus, our sights all along the line have been raised. Plans cast in terms of the old standards are obsolete. All these developments impinge in innumerable ways upon the problems of state and local governments.

The American people are citizens of a great unified nation. The tasks of the nation as a whole must, however, be carried forward under a federal system of government. A nation so large in geographic extent and so varied in its industrial and social development demands a large reliance upon local responsibility and local government.

The conflict between different levels of government is frequently posed in unrealistic terms. Too often it is assumed that a vigorous state government, for example, implies a diminution in the sphere and influence of local government, and, similarly, that enlarged activities of the federal government encroach upon the proper functioning of state governments. It can, however, be demonstrated, we think, that only when the higher levels of government play their appropriate role vigorously and efficiently are conditions created under which subordinate units of government can effectively carry out the functions appropriate to them. It is where state governments are strong and vigorous that efficient local government flourishes. Experiences of recent years have demonstrated that when problems which transcend the power of state and local governments are not vigorously attacked by the federal government, state and local government becomes unworkable.

The American people have unanimously throughout their history set themselves new goals for the nation as a whole in terms of political,

social, and economic progress. These national goals can only be effected through the three levels of government, each playing its appropriate role, and not by any artificial departmentalization of the three governmental levels. Thus, despite the fact that we operate in a federal system, the programs which we seek to carry through are national in scope, involving appropriate action at each governmental level.

Fiscal policy has an important role to play in all this. Under modern conditions, many things must be done by collective action. Public finance underlies, of necessity, community action. It is, therefore, of the utmost importance that the financial machinery of government and the intergovernmental fiscal relations be geared to the requirements of present-day society.

Too often financial problems are treated within the pattern of a static system. Energies are expended upon patching up or plugging holes where they might better be directed toward ways and means of improving the economic base and developing a sound foundation upon which the various governmental fiscal structures may be built.

The main problems in intergovernmental relations center around shifts in financial responsibilities. Any realistic appraisal of the American governmental structure, and what is necessary to make its functioning effective, must take cognizance of this pivotal fact. At the same time, however, it is important to realize that while the federal government may rightly make contributions toward the support of essential social services, the major control of the actual administration will still, in the typical case, remain at the state or local level. Thus we approach our problem on the assumption that the values associated with local self-government are very real and important.

I wish to express my great obligation to the Graduate School of Public Administration, Harvard University, for the seminar and research facilities which it has made available. I am, moreover, deeply indebted to the Board of Governors of the Federal Reserve System for placing at my disposal the efficient services of its library and its ample research resources.

My appreciation and thanks are especially due to Miss Margaret Hough for her highly efficient secretarial work, to Harvey S. Perloff for his co-operation which has made this a joint product, to Evsey D. Domar, Julius Margolis, and Walter F. Stettner for invaluable re-

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Finally I wish to express my deep appreciation for the stimulation of frequent and continued discussion with Dean John H. Williams of Harvard on the broader aspects of fiscal policy and its relation to monetary policy.

The authors alone assume full responsibility for the opinions expressed and for errors which may inadvertently have escaped their attention.

Although one of the authors of this book is now a member of the Army of the United States, his work on the book was done before his entry into military service. The opinions expressed in this book are not to be taken as those of the War Department.

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PART ONE

The Problems and Deficiencies

Chapter One

WARTIME AND POSTWAR PROBLEMS

WARS and depressions create serious problems for state and local governments. Quite new problems are cast up by the conversion of the economy to war and by the postwar reconversion and readjustments. Moreover, the war upheaval tends to magnify and intensify the continuing and evolving problems of local governments. Deep seated and fundamental maladjustments and deficiencies in governmental structures and intergovernmental relations are laid bare.

The inflationary development in World War I, the subsequent deflation, the boom of the twenties, and the great depression of the thirties confronted the states and localities with quite intolerable situations. Local governments found it impossible to cope adequately with the new conditions. A larger role of the federal government became inevitable. These new developments had not yet shaken down into any rational pattern before World War II set going new waves of disturbance which in the end may affect local government even more profoundly than those engendered by World War I. Intergovernmental relations in the United States are thus currently in a state of flux, uncertainty, and change. It is, therefore, peculiarly necessary and important to think through the problems of federal-state-local fiscal interrelationships and to evolve procedures and programs adequate to cope with these new developments.

WARTIME PUBLIC-SERVICE DEFICIENCIES

The military and industrial mobilization of the country has brought far-reaching shifts in industry and population. The rapid conversion to war production, the expansion of employment and output, have made us aware how dynamic our society is. To meet rapidly evolving problems and ever-changing situations, it has been demonstrated, states and localities must possess a high degree of flexibility; they must be prepared to adjust fiscal policies and structures.

The communities which have become centers of war activity are faced with many pressing problems. The influx of population has compelled the provision of new or greatly expanded services. Few of these war centers have been able to meet the new demands without substantial aid from the central government. In a large number of cases the chaotic and unhealthy conditions within communities are the result of long standing deficiencies in community facilities, such as water supply, sewerage systems, and housing.

The location of war plants in rural areas, outside of municipal jurisdictions and distant from city facilities, has created for certain local governments a critical situation. Located in areas outside of city limits, business concerns escape municipal taxation despite the fact that the local governmental units provide all manner of services which make possible the availability of a labor force. For example:

The Willow Run bomber plant is not only outside of the limits of the City of Detroit, it is outside of Wayne County. The Ford Motor Company recently objected to the construction of permanent houses in the vicinity of the Willow Run plant. It was suggested that the workers come from Wayne, Ypsilanti, Inkster and Detroit. We will say nothing about the problem of transportation, but this of course means that housing, sewers, water, schools, hospitals for the workers in the Willow Run plant must be provided by Wayne, Ypsilanti, Inkster and Detroit; and if relief becomes necessary and is paid for in any part by the local community, the responsibility will be that of the communities mentioned and not of the Willow Run plant. The tax base is in Washtenaw County, but Detroit and Wayne County are expected to provide the services for the workers in the plant. The Hudson arsenal and the Chrysler tank plant are not only outside of the City of Detroit, they are outside of Wayne County. Here again the tax base has been moved outside of county limits, but the City of Detroit is supposed to provide the services for the workers and it must be remembered that no large city can support its

public services from the taxes received from residential areas only. It should be kept in mind, also, that these plants which are going beyond the city limits are the new plants, the modern factories, and it is not inconceivable that certain of the industries now to be found within the city limits will move to the new plants when the war is over.¹

What happens when an industry locates in a rural area—without adequate provision being made for the workers who reside near the plant—can be illustrated by referring again to Washtenaw County. The influx of population within the county has been striking. In Ypsilanti Township, for example, the population increased from 4,153 in 1940 to an estimated 26,000 in 1943. The five so-called critical areas in the county have been without a municipal water supply, a sewage disposal system, garbage and refuse collection system and other such necessities for an urbanized area.² A survey of the homes in one of these critical areas revealed that all (184) had unapproved private water supplies, 115 used unapproved privies, 64 relied on unapproved septic tanks, 161 used some form of unapproved garbage disposal.

The location of plants far removed from the cities which supply the workers and which service them has also brought serious transportation difficulties. Workers have traveled 10 to 50 miles to and from work. Narrow country roads suddenly called upon to carry abnormal loads have become congested, with traffic snarls taking valuable time to untangle. In a number of instances, workers have had to consume one-fourth to one-half as much time in travel as they spend on actual work in the plant.

The housing and health conditions in a number of defense centers are critical. Overcrowding characterizes most of these areas. Many of these communities, as revealed by the Census of Housing, had inadequate housing facilities even before the war program got under way. In the City of Pittsburgh, for example, according to the 1940 census, 43.5 per cent of dwelling units were in need of major repairs and / or

¹ Walter H. Blucher, "What is Happening to Cities," *Municipal Government and the War*, Proceedings of the Nineteenth Annual Conference of the American Municipal Association, November 1942, p. 36.

² O. K. Engelke, J. R. Cameron, and J. F. O'Brien, *A Description of Health Problems in the Area of the Willow Run Plant of the Ford Motor Co., Washtenaw Co., Michigan, as of 2/27/43* Report of the Office of Defense, Health & Welfare, Washtenaw County Health Dept., Ann Arbor, Michigan, mimeographed.

without private bath, and 9.4 per cent had 151 or more persons per room (the census indicator of crowded conditions). A large number of the defense centers, in addition, had no public health clinics or nursing services.

HUMAN RESOURCE DEFICIENCIES REVEALED BY THE WAR

The Selective Service examinations have revealed serious deficiencies in education and health. For many it was a shocking revelation to learn that in the United States many of our young men lacked even the barest minimum army standards of "functional literacy" and that many were disqualified for military service by reason of preventable and curable ills.

According to a directive issued in May 1941, induction was refused to men who were unable to pass an examination roughly measuring the educational achievement of a fourth grade school child. These men are referred to as "functional illiterates." It was recognized that they lacked the tools with which they could become efficient soldiers of an army in which the blueprint, diagram, and map are everyday aids to action. But the number of men so refused for service mounted alarmingly in a few months. Officials were instructed to accept 10 per cent of these functional illiterates.

It is estimated [in March 1943] that there are still in the reservoir of those who face induction, *not counting the class of the 18-20-year-olds*, the staggering number of 750,000 men who disqualify for service solely because they lack sufficient education. Of those who so disqualify, 500,000 are white, 250,000, Negro. Most of these men, naturally, are inhabitants of those areas of the United States where the census has shown decade after decade the largest percentage of illiteracy. It ought not to be difficult to place the responsibility for this lack. It is time to quit trying to fix the *blame* for it and to make the *responsibility* clear. These men are not being called to the service of any state or group of states, north, south, east, or west—they are being called to the service of the federal government.³

Table 1 gives the percentage of various age groups with less than four years of schooling. The inadequacy of our elementary-school provisions is, however, worse than these figures indicate, since the quality and months of training are not revealed in a table of this sort. A prac-

³ Belmont Farley, "The Alphabet and the Army," *The Journal of the National Education Association*, Vol. 32 (March 1943), pp. 77-78.

tical test of ability to read and write discloses a much higher rate of illiteracy than these figures would indicate.

TABLE 1. Education of Men 18 to 44 Years of Age, 1940

Per Cent with Less than 4 Years
of School

Ages	All Classes (U. S.)	White (North)	White (South)	Negro (South)
18-20	3.8	0.9	5.6	21.1
21-24	4.0	0.8	5.7	24.7
25-34	4.6	1.3	6.3	27.3
35-44	7.4	3.7	9.1	35.3
18-44	5.3	2.0	6.9	28.4

Source: U. S. Bureau of the Census, *The Educational Level of Men of Military Age in the U. S.*, 16th Census, 1940, Series P-9, No. 15, June 20, 1942.

The rejection for military service because of physical and mental defects is unnecessarily high. Of the first two million men examined, about 45 per cent were rejected for general military service. After the Pearl Harbor attack, physical standards were lowered somewhat, but even then, the rejections were 35 per cent. In the 45-year group, 85 per cent were found to be unfit.⁴

A sample study of physical-examination reports, made just before the American entry into the war, indicated that the rate of rejections for general military service was 41 per cent of those examined (Table 2). Of this sample, 21 per cent of those unqualified for general military service had defective teeth. Diseases and defects of the eyes were the cause of rejection for 13.7 per cent. Other major causes were cardiovascular 10.6 per cent, musculoskeletal 6.8 per cent, venereal 6.3 per cent, mental and nervous 6.3 per cent, hernia 6.2 per cent, ears 4.6 per cent, feet 4.0 per cent, and lungs 2.9 per cent.⁵ Many of these defects are curable and most are preventable.

WARTIME FINANCE

The war has profoundly affected state and local finances. On the expenditure side, limitations on construction and the sharply reduced

⁴ Col. L. G. Rowntree, Chief of the Medical Division of the National Selective Service, *New York Times*, April 3, 1943, p. 17.

⁵ Selective Service System, *Analysis of Reports of Physical Examination*, Medical Statistics Bulletin No. 1 (Washington, November 10, 1941).

TABLE 2 Percentage of Registrants Not Qualified for General Military Service, by Ages

Age	Qualified for Limited Military Service Only	Disqualified for any Military Service
18 *	5.2	10.5
19 *	9.1	8.4
20 *	13.4	12.6
21	16.7	12.8
22	19.0	13.7
23	17.5	15.6
24	18.3	16.4
25	19.6	19.3
26	18.5	20.8
27	22.5	20.1
28	24.3	21.9
29	25.4	22.8
30	26.0	28.0
31	27.0	29.1
32	27.6	31.0
33	28.1	29.7
34	26.4	38.4
35	32.6	34.0
36	34.4	35.7
Total	21.0	20.0

Source: Selective Service System, *Analysis of Reports of Physical Examinations, Summary of data from 19923 Reports of Physical Examination*, Medical Statistics Bulletin No. 1 (Washington, November 10, 1941), p. 5.

* Nonregistrants who are volunteers. Col. Rowntree approximates that 29 per cent of this group were rejected at a later date with lower standards.

relief costs have, in most cases, resulted in reduced budgetary outlays. It is important to note, however, that the rise in the cost of living has been reflected in increased expenditures by state and local governments for personnel and matériel. As the Budget Director of New York City has put it, "Higher wages and higher prices through inflation hang as a constant threat over every municipality."⁶

The trend in tax collections thus far has been favorable. Total state tax collections increased from \$4,418 million in fiscal 1941 to \$5,099

⁶ Kenneth Dayton, "Effect of War on Costs of Local Government," *Wartime Problems of State and Local Finance*, Tax Institute Symposium (Philadelphia, 1943), p. 27.

million in fiscal 1943.⁷ It is interesting to note here that whereas total state tax collections increased 15.4 per cent during this period, state corporation income taxes increased 98.4 per cent. In spite of this increase the corporate net income-tax yield still made up only 7.2 per cent of total state collections. A spectacular increase in collections from individual income tax also took place in those states which did not reduce their rates. Nevertheless this tax comprised only 6.1 per cent of total state tax collections in 1943. Thus it can be seen that the taxes which most reflect the increasing volume of business and the increasing payrolls form only a small part of the state tax structures. At the same time, sales and gross-receipts taxes, which comprised 41.9 per cent of total state tax collections in 1943, increased only by about 17.3 per cent from 1941 to 1943, or at just about the same rate as the total tax increase.⁸

At the local level, a major revenue problem is that of the increase in tax-exempt property. "This problem, already acute in certain cities because of a liberal policy of subsidies through tax exemption, has been intensified as a result of the war. The establishment of defense housing projects, federal military zones and camps, hospitals, shipyards, war industries plants, and other fully or partially exempt properties has still further narrowed the tax base."⁹

In spite of the urgent need for co-ordinated wartime fiscal policies at all levels of government, a large number of states and localities have pursued policies contradictory to those recommended by their own national associations.

The Council of State Governments has urged states and localities, in view of the wartime inflation problem and postwar needs, to: (1) pay off debts, (2) restrict expenditures, (3) build up reserves and sterilize such reserves in dormant bank deposits or in federal government bonds, (4) maintain tax rates consistent with the national and state economy, (5) prepare to offset possible postwar depressions by develop-

⁷ U. S. Bureau of the Census, "State Tax Collections in 1943," *State Finances*, 1943, Vol. 2, No. 2 (Washington, August 1943), p. 5.

⁸ *Ibid.*, p. 3, and *State Tax Collections 1941* (Washington, February 1942), p. 15. The figures for sales tax collections for 1941 and 1943 are not quite comparable because of a change in Census classification.

⁹ Edwin H. Spengler, "Effect of War on Property Tax Collections," *Wartime Problems of State and Local Finance*, Tax Institute Symposium (Philadelphia, 1943), p. 60.

ing programs and blueprints for special works and services, and by accumulating means of financing them.

The Municipal Finance Officers' Association has recommended, among other things, that:

- 1 Finance officers should study the effect of their current decisions with respect to the adjustments that must be made following the close of the present war
- 2 Plans should now be made and prepared in detail for postwar public improvements
- 3 The financing of necessary public improvements in the postwar period may be facilitated
 - (a) By the progressive reduction of state and local government debt to the end that credit will be available through improved borrowing power, and
 - (b) The exercise of operating economies to the end that reserves or surpluses may be created and that where needed, legislation should be enacted in all states . . . to accomplish this purpose ¹⁰

Unfortunately, adherence to these principles by the individual states and localities has been far from universal. Indeed, contrary to these recommendations, in a number of instances tax rates have been drastically reduced. In 1942, the New York personal income tax was reduced by 25 per cent. Iowa followed in 1943 with a 50 per cent reduction, and Maryland with a 33⅓ per cent cut. South Dakota repealed its income tax altogether. Oregon has reduced its rates by about one-third.¹¹ The West Virginia legislature passed over the governor's veto an act repealing the state's 10-year-old personal income tax law. Illinois has lowered its general sales tax rate, while Indiana reduced the rates of its gross-receipts tax. Of major importance is the fact that in a number of states there is serious agitation for tax reduction. A report prepared for the National Municipal League revealed that during 1942, cities with populations between 30,000 and 500,000, taken collectively, decreased tax rates, averaging \$.05 per \$1,000 of assessed value, from the 1941 levels.

The general improvement in state finances has resulted in some

¹⁰ Resolutions adopted at the Municipal Finance Officers' Association, 37th Annual Conference at Buffalo, New York, on June 22 and June 24, 1942. *Municipal Finance News Letter*, July 1, 1942, p. 7.

¹¹ George H. Watson, "Recent Trends in State Revenues," *The Book of the States 1943-1944*, Vol. V (Chicago, 1943), p. 172.

reduction of debt. This reduction, however, has been on a relatively small scale—\$113 million in fiscal 1941, \$202 million in fiscal 1942, and \$302 million in fiscal 1943.¹² In certain states, moreover, indebtedness was increased during the fiscal year 1942. Some states have indicated that they are planning to employ current surpluses in the reduction of their debt. Virginia has set aside \$10 million in addition to other sinking-fund assets to be invested in federal securities maturing in those years in which its own debt falls due.

A few states have thus far explicitly established postwar reserves, while several states have authorized certain of the subdivisions to create reserve funds for future public works. No considerable use has been made as yet of the state enabling acts, although interest in the subject of reserves has greatly increased in the states which have authorized the creation of local reserves.

While the combined state and local budgetary surplus in 1940-42 was considerable—about 10 per cent of total expenditures—nevertheless many states and localities have not accepted fully the responsibility for following fiscal policies which would help temper current inflationary pressures and which would ease the process of economic readjustment in the postwar period.

One of the hopeful elements in the wartime situation is the increasing tendency on the part of federal, state, and local officials to meet together in order to discuss common problems and to recommend consistent policies. This is an important first step in achieving co-ordinated economic and fiscal policies at all levels of government.

PROBLEMS OF POSTWAR READJUSTMENT

While no one can foresee with precision the problems with which the states and localities will be confronted in the postwar world, it is clear that they must be ready to cope, if need be, with violent fluctuations in economic activity and with drastic shifts in industry and population.

Industry relocation and migration of workers are certain to take place in considerable degree when the nation returns to peacetime production. Such shifts will bring with them a variety of problems for states

¹² U. S. Bureau of the Census, "State Debt on June 30, 1943," *State Finances*: 1943, Vol. 2, No. 3 (Washington, September 1943), p. 1.

and localities. A number of the war centers which have mushroomed under the impact of the war-production program—especially communities which have grown around powder and chemical plants, ship-building, and the like—will be faced with an extremely unpleasant task. They will have to adjust themselves to a much smaller population and to a much reduced level of activity. Certain of the facilities constructed to accommodate war plants and war workers will have to be dismantled. Common sense dictates that arrangements be made for shifting material and equipment still in good use to near-by areas which will expand in the postwar period at the same time that such war centers contract. One of the most difficult problems in the transitional period will be that of achieving a balance between providing employment through the construction of public works in those communities which are suffering from temporary dislocations, on the one hand, and, on the other, avoiding the building of additional capital improvements in those communities which must necessarily lose a large percentage of their industries and population after the war-production program comes to an end. It is extremely important to avoid freezing an unsound, uneconomic situation or hindering labor mobility.

War centers, uncertain of maintaining their present level of activity in the postwar period, should take advantage of the current opportunity to raise large tax revenues in order to provide for current and future needs. Unless they do so, they may at a later period find it necessary to impose a very heavy tax burden on the relatively small remaining population to pay for facilities built to accommodate a war-peak population. It is far better to err on the side of liberality in the setting of current tax levies¹³ than to be faced with the necessity of increasing tax burdens at a time when such burdens may accelerate an economic decline.

If, in the postwar period, there is a continuation of the current trend to locate industry in rural areas outside the tax jurisdiction of urban communities, local governments will be faced with an extremely embarrassing fiscal situation. Measures need to be taken to cope with this problem.

The state and local governments must also be prepared to meet the problems of cyclical fluctuations. In the past, at any rate, our economy

¹³ Surpluses can be used to great advantage for the repayment of debt or for the establishment of reserves for postwar purposes.

has been subject to violent fluctuations. Witness the fact that our national income fell from \$83 to \$40 billion from 1929 to 1932, and rose to \$148 billion in 1943. Such extreme fluctuations must not be permitted to occur again. Nevertheless, the states and localities should be prepared to meet the problems arising from fairly large cyclical fluctuations. Unless they are prepared, the federal government will have to carry a disproportionate share of the burden. According to Census figures, for example, the proportion of total state and local construction which was federally financed rose from 3.5 per cent in 1928 to 69.0 per cent in 1936.¹⁴ In periods of stress, questions of "centralization" and "home rule" cannot be expected to make much of an appeal to the majority of the people. To a very large extent, the scope for state and local activity will depend on the ability of these governments to strengthen their revenue bases and to rationalize their fiscal structures.

Inflation in the postwar period would also seriously disrupt state and local finances. Aside from the effect of steadily rising costs of living on the citizens of state and local communities, inflation presents manifold problems for state and local governments. The constant pressure for increasing employees' wages, the rising prices of materials, together with the inevitable lag in tax collections, would render budgeting a precarious task and would make the provision of adequate services extremely difficult. Thus local governmental units are greatly concerned that the cost of living should not be permitted to rise.

BASIC MALADJUSTMENTS AND DEFICIENCIES

Underlying many of the wartime and postwar problems discussed above are certain maladjustments and deficiencies in the fiscal, economic, and governmental structures of the states and localities. This book focuses attention especially on these maladjustments and deficiencies and on possible methods of overcoming them. Some of the basic problems are outlined below:

1. Certain areas of the country are characterized by: (a) extremely low per capita incomes; (b) a depletion of natural resources in-

¹⁴ U. S. Bureau of the Census, Div. of State and Local Governments, *Financing Federal, State and Local Governments 1941* (Washington, September 1942), p. 76.

volutioning the undermining of the economic base; and (c) a serious depreciation in property values.

2. Urban communities, in general, suffer from the lack of over-all planning. Spreading blight, premature subdivision of land, decentralization, etc., confront local governments with many serious problems. The decline in the property-tax base and the high cost of supplying municipal services are direct concomitants of the lack of comprehensive planning and of inadequate land control.
3. State and local governments are faced with serious limitations with respect to the taxes which can be employed and the rates which can be applied. Among other aspects of this problem are: (a) dependence on regressive and repressive taxes, (b) rigid tax limitations and extensive property-tax exemptions (including homesteads, certain classes of business, and public properties), (c) interstate competition for mobile business and wealthy individuals, (d) undermining of the local tax base through decentralization and spreading blight and slum.
4. Fiscal embarrassment is often caused by high overhead costs due to a heavy burden of local debt, inability to borrow funds except at extremely high interest rates; and by rigid debt limitations.
5. Local responsibilities to provide services are frequently not matched with adequate fiscal capacity.
6. An impressive number of communities throughout the nation are unable to supply services at anything resembling an adequate standard. Inequitable and unsound tax burdens frequently prevail as a result.
7. States and localities in general have not yet accepted responsibility for pursuing fiscal programs which would contribute to the progress and stability of the national economy as a whole.
8. Finally, in a federal system such as ours—made up of over 165,000 governmental units—problems of serious proportions arise from the fact that the degree of co-operation and policy co-ordination between governments which is necessary in our complex and unstable economic order has not yet been achieved or even approximated.

In looking toward possible solutions of the more important problems of state and local finance, it is essential to keep before us the

picture of our present deficiencies. These shortcomings can be measured most fruitfully in terms of three major objectives: (1) the provision of an adequate level of social services everywhere, (2) the extension of the democratic ideal in terms of equality of opportunity and equity in tax burdens, and (3) the making of the maximum contribution to the progress and stability of the economy.

Chapter Two

SERVICE LEVELS AND RELATIVE RESOURCES

THERE are wide and indefensible differences in service standards both among and within the states. The accident of place of residence of the American citizen determines in large measure the adequacy of the educational, health, and recreational facilities with which he is provided, as well as the extent of protection afforded him against unemployment, old age, and other contingencies.

Complete equality in service levels is in the nature of the case unattainable so long as there remain wide differentials in productivity, wage and income levels in the different parts of our vast country. The removal of these inequalities depends fundamentally upon raising the productivity in the backward areas. Yet in some measure, grants to the poorer areas, varying according to need and enabling them to maintain minimum service standards, are essential in the interest of the nation as a whole. Gross inequalities in basic and essential social services are wholly incompatible with the democratic principle of equality of opportunity.

Many communities simply cannot afford to provide a level of social services at all commensurate with this ideal. In spite of the fact that the poorer states and localities generally make a greater effort—in terms of their taxable resources—to raise revenues than do the richer units, they are not able to maintain satisfactory service standards. The ability of a state or local government to provide adequate social services depends essentially upon its ability to raise revenue. Accordingly, the relative levels of services provided follow closely the pattern of income distribution among the states and among the localities. Yet in a great national economy such as ours, the income received by the residents of our wealthier communities is derived from the national market as a whole, and is not limited to economic processes within their own local political boundaries. The poorer states cannot be regarded as "foreign countries"; they are parts of a national economic entity.

EDUCATION—THE OPEN DOOR TO OPPORTUNITY

A basic tenet of our democracy is that the channels through which individuals can pass to higher living standards and cultural levels should be kept open. Every individual—and particularly every child—should be afforded the opportunity to develop his capacities to the maximum.

"The American people are committed to the principle that all the children of this country, regardless of economic status, race, or place of residence, are entitled to an equitable opportunity to obtain a suitable education, so far as it can be provided in the public schools. The principle has never been fully recognized in practice."¹

How far short we are of realizing this principle is indicated by a report (1939) of a subcommittee of the Senate Committee on Education and Labor. This report reveals that:

Between 800,000 and a million children of elementary school age are not enrolled in school at all, mainly because of lack of facilities in many scattered rural areas that are impoverished and isolated. For these children freedom and opportunity have proved to be chiefly freedom and opportunity to grow up in ignorance.

In the United States there are still more illiterates than college graduates and about half as many illiterates as high school graduates. There are in this country approximately 3,600,000 totally illiterate persons and about 15,000,000 other adults who cannot read a newspaper nor write a simple letter. In 1 State only 0.8 per cent of the population over 10 years of age are illiterate, while in another State 14.9 per cent are illiterate. The first State is about 3 times as able financially to support schools as the second, and spends about 3 times as much per capita for education.

The public library is recognized as an important educational agency in our American democracy. Among the 3,100 counties in the United States only 400 have public libraries, and there are more than 1,000 without even a town or city library within their borders. About one-third of the people of the United States have access to good libraries. Another one-third have libraries, but very meager ones, chiefly in the smaller cities and larger towns. The remaining one third have no public libraries of any kind. Most of these people live in rural areas and country towns in every section of the Nation. These people constitute 45,000,000 of America's citizens, of whom 39,500,000 live in rural areas. They do not have library services for much the

¹ The Advisory Committee on Education, *Report of the Committee* (Washington, 1938), p. 4.

same reason that they do not have adequate public-school or public-health services, namely, the poverty of local resources . . .

The differences in breadth of educational opportunity, resulting from the statistical data cited above, are correspondingly great. Hundreds of rural schools can be found which are the merest shacks, in which the children are huddled together in makeshift desks, using a small number of dirty and worn-out textbooks under the direction of teachers who themselves have hardly finished high school. One fourth of the teachers in our one room rural schools have never had a day of work in a school beyond the high school. In thousands of these schools it is virtually impossible to provide the health, welfare, guidance, and other services that children need in addition to instruction. On the other hand, in some wealthy communities there are public schools which would seem almost perfect, where the buildings are the finest specimens of modern architecture, where teachers are well trained, well paid, and competently supervised, where the children are given individual attention, and where everything is done to foster their physical and mental development. Although equality of opportunity is a fundamental tenet of our democracy, inequality of opportunity is at present the dominant characteristic of our educational system when viewed from the national standpoint.²

Extreme inequality in educational opportunities exists both among the states and within the states. Chart I (p. 17) presents a striking picture. It reveals the great differences which exist in the amounts spent for the education of a school child in each state.³ The outlays shown are average expenditures for 1939-40, within the respective states, and include expenditures both of state and local funds. The range in expenditures is from \$31 per pupil (in average daily attendance) at one extreme to \$157 per pupil at the other. The chart reveals further that educational expenditures correlate closely with per capita income, or economic capacity, so that educational levels decline as economic resources decrease. In addition, the educational load in terms of ratio of children to adult population is distributed very unequally among the states and between the rural and urban population. The chart also reveals that the heaviest educational load falls on the productive work-

² "Federal Assistance to the States for the Support of Public Education," *Report* (No. 244), on S. 1305, 76th Congress, 1st Session (April 3, 1939), pp. 3-5.

³ Expenditures per school child may be used as a rough measure of educational opportunities, since in general there is a direct correlation between expenditures per school child and the quality and amount of service provided.

CHART I
Education: Service Levels and Needs

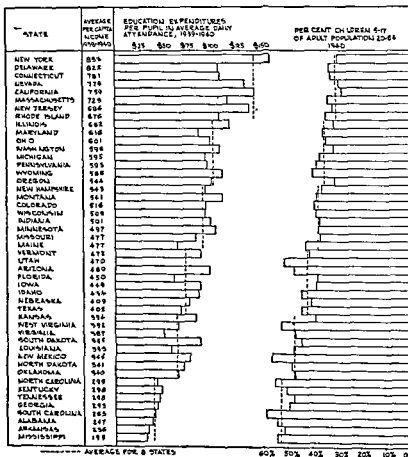


TABLE 3 Education:

State	Average Per Capita Income, 1938-40	Education Ex- penditures Per Pupil in Aver- age Daily At- tendance, 1939-40	Per Cent Children 5-17 Years of Age, of Adults 20-64 Years of Age, 1940
N Y.	\$853	\$156 86	30 0
Del.	822	108 52	33 5
Conn.	781	109 18	32 9
Nev.	779	131 35	29 6
Calif.	759	141 93	28 0
Mass.	723	114 52	34 0
N J.	686	136 42	32 0
R I.	676	105 17	34 7
Average for group	784	140.72	30 6
Ill.	662	115.19	31.4
Md.	616	83 81	35 9
Ohio	601	96 37	34 6
Wash.	596	105 31	31.3
Mich.	595	92 38	37.3
Pa.	593	92 45	38 5
Wyo.	586	108 51	40 0
Ore.	544	97 42	30 9
Average for group	610	98 29	35 2
N H.	543	91 31	36 6
Mont.	541	109 07	38.3
Colo.	516	92 04	39 0
Wisc.	503	91 07	38.4
Ind.	501	96 13	37.1
Minn.	497	100 38	37.9
Mo.	477	80 36	36 4
Me.	477	63 50	42 7
Average for group	498	88 34	37.8

Sources Education expenditures U. S. Office of Education, *Advance Statistics of State School Systems, 1939-1940* (Washington, May 1942), Release

Population—children 5-17 *Advance Statistics of State School Systems, 1939-40.*

Service Levels and Needs

State	Average Per Capita Income, 1938-40	Education Expenditures Per Pupil in Average Daily Attendance, 1939-40	Per Cent Children 5-17 Years of Age, of Adults 20-64 Years of Age, 1940
Vt.	\$472	\$85.08	41.4
Utah	470	78.47	51.8
Ariz.	460	96.26	47.8
Fla.	450	58.35	38.0
Iowa	449	86.47	38.2
Idaho	434	78.05	44.3
Nebr.	409	74.41	40.2
Texas	402	65.87	44.2
Average for group	425	71.97	42.2
Kan.	394	82.73	38.6
W. Va.	392	63.71	52.8
Va.	387	47.91	46.9
S. Dak.	355	85.50	44.6
La.	353	56.58	47.7
N. Mex.	345	76.36	56.8
N. Dak.	341	68.87	48.1
Okla.	340	63.03	47.7
Average for group	368	63.66	47.1
N. C.	299	40.86	55.6
Ky.	298	46.78	51.0
Tenn.	298	44.29	47.7
Ga.	293	42.16	49.8
S. C.	263	39.68	59.0
Ala.	247	36.16	54.6
Ark.	236	31.35	51.9
Miss.	199	30.72	54.3
Average for group	272	39.44	52.7

—Adults 20-64: *Statistical Abstract of the United States* 1941, p. 43

—Total 1938-40: *Statistical Abstract of the United States* 1941, pp. 4-5, 10.

Income payments: *Survey of Current Business*, July 1942, pp. 23-26.

ers (adults 20-64 years of age) in the poorest states. In the eight poorest states, all in the South, there are 527 children 5-17 years of age per 1,000 adults 20-64 years of age. In the eight richest states, there are only 306 children of school age per 1,000 productive adults.⁴

It is just in the communities where the educational need is the greatest that the economic resources are the most limited. There the local support of education is far below an adequate level and the community has the least to offer for the intellectual development of youth. Chart II presents a picture of the broad educational service levels among the states, revealing a distinct regional pattern.

The major reason for the great inequality in educational opportunity is the manner in which financial support is provided for the public schools.

Notwithstanding an increasing amount of financial support through other taxes levied by states, over three quarters of the annual cost of public education is met through taxation of property, chiefly by local jurisdictions. Because of this situation, the fortunes of education rise and fall with the ability and willingness of real estate owners to pay taxes. No other great social service is dependent so largely upon so unsatisfactory a tax base.⁵

Most of the 120,000 school jurisdictions in the nation raise their taxes separately. It is inevitable that real-estate values in school districts should frequently be entirely out of proportion to the number of school children. In a number of states, the most prosperous local units can provide \$100 or more per child for every \$1 provided by the poorest units.

HEALTH AND MEDICAL CARE

A healthy mind and body are essential to the full development of individual capacity and to the attainment of a satisfactory standard of living. Human conservation has, therefore, long been recognized as a public responsibility. Yet a very large proportion of local communities lack adequate medical care and institutional health facilities.

A survey by a technical committee (1939) of the Interdepartmental

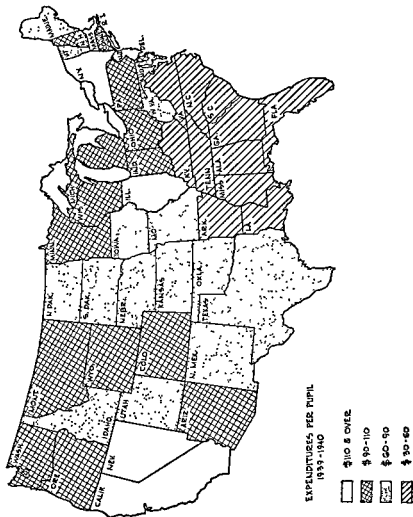
⁴ The differences among states in the ratio of children to adults reflects to a large extent differences in the ratio of rural to urban populations in the various states. In substantially every state, the adult group in the rural population is carrying an educational load, in terms of number of children to be educated, that is far in excess of the load carried by the adult group in urban areas.

⁵ The Advisory Committee on Education, *op cit*, p. 19.

CHART II

Education: Service Levels

Current Expenditures per Pupil in Average Daily Attendance, 1939-40



Committee to Co-ordinate Health and Welfare Activities revealed that ⁸

1. Preventive health services are grossly insufficient in most parts of the country. Less than a third of the counties and even a smaller proportion of the cities employ full time professional health officers. Not more than half of the state health departments are adequately staffed or satisfactorily equipped to render services which they alone can give. Through their health departments, states expend on the average per annum only 11 cents per capita, while in some state appropriations fall as low as 3 cents per capita.

2. Hospital and other institutional facilities are inadequate in many communities. Financial support for hospital care and for professional service in hospitals is both insufficient and precarious. This is especially true of services to people who cannot pay the cost of the care they need. Forty per cent of the counties in the United States have no registered general hospitals (these counties, in the aggregate, contain about 17 million people), while more than two thirds of the states have fewer general-hospital beds than are considered adequate by professional standards. Professional judgment indicates that an average of 45 beds per 1,000 population must be maintained to provide adequate general hospital facilities. Only nine states meet this standard of adequacy. The position of the various areas of the nation with respect to economic resources (not the hospital needs of the population) determines, in general, the extent to which facilities are developed. This is true not only of general hospitals, but also of mental and tuberculosis institutions.

3. About one-third of the population are receiving inadequate medical service and in many cases no medical care whatever. To take one example, in 1936 there were nearly one-quarter of a million live births in which there was no physician in attendance at the birth. In 713 counties (69 urban, 644 rural) 25 per cent or more of the infants born alive were delivered by midwives, known to be ignorant and untrained. The per cent of hospital births varied greatly from state to state, being highest in Connecticut (83 per cent) and New York (80 per cent) and lowest in Arkansas (9 per cent) and Mississippi (8 per cent). In rural parts of Alabama only 2 per cent of births were in hospitals, in rural

⁸ Interdepartmental Committee to Co-ordinate Health and Welfare Activities, *The Nation's Health* (Washington, 1939), Ch. III.

parts of California, 66 per cent. Only 2 per cent of births in the 16 states with the highest per capita income were not attended by a physician, while in the 16 states with the lowest income per capita 25 per cent of births were not attended by a physician. Other aspects of medical care follow very much the same pattern. Economic resources rather than need determine the level of service, so that individuals residing in the poorer areas of the nation are generally denied the protection of adequate health and medical services.

SOCIAL SECURITY AND WELFARE

Provision against individual want and insecurity is now accepted as a basic public responsibility—a responsibility shared by the federal, state, and local governments. As yet we are far from having achieved the goal of "minimum security for all."

A very large number of workers are not covered by the unemployment insurance system. Certain fields such as agricultural labor, domestic and maritime service, employees of nonprofit organizations, and government employees are specifically excluded from the federal law; workers in establishments employing less than 8 persons (for 20 weeks) are excluded as well. The states, in general, follow the federal exclusions, with numerous variations.⁷ The total number of additional persons in civilian occupations who might well be covered by unemployment insurance is very large, probably over 10 millions. In addition, it has been estimated that minimum earning requirements restrict the eligibility of about 17 per cent (as of 1940) of all covered workers.⁸ Another sector of our working population is either excluded or else qualifies only for lower benefits because of interstate migration.

Even those workers who are fortunate enough to be included in the existing system have a very thin protection against unemployment. Thus a survey of the problem in 39 states has revealed that:

Even during the relatively prosperous period studied [1940-41] when periods of unemployment were relatively short and benefit rights maximized

⁷ Social Security Board, *Comparison of State Unemployment Compensation Laws as of December 31, 1941*, Employment Security Memorandum No. 8 (Washington, 1942) pp. 11-21.

⁸ National Resources Planning Board, *Security, Work, and Relief Policies*, Report of the Committee on Long range Work and Relief Policies (Washington, 1942), p. 212.

in most states by base periods of relatively high earnings, about half of all beneficiaries in the states studied exhausted their benefit rights. In only two states—Maine and New Hampshire—did less than 40 per cent of all beneficiaries exhaust their rights, and in five states—Florida, Montana, New Jersey, Oklahoma, and Texas—the proportion was 60 per cent or more. Past experience indicates that in depression times the duration of benefits provided by state unemployment compensation laws, and particularly by those which relate duration of benefits to prior earnings, will be far below the levels necessary to carry most beneficiaries through their spells of unemployment.⁹

And when benefits are exhausted, the worker has nothing else to do but fall back on relief—if the latter is available.

State unemployment benefits are usually computed on the basis of wages received with a specified maximum and minimum amount. Thus unemployment benefits necessarily correlate directly with the economic resources within the various states. That this is so emphasizes again the importance of raising the productivity in the poorer sections, thereby reducing the wide differential which now exists and helping to raise the minimum benefits to a reasonably satisfactory level.

On February 18, 1943, minimum weekly benefits for total unemployment for the eight richest states arranged in descending order in accordance with per capita income payments in the period 1938-40 were, in turn, \$7, 5, 6, 5, 10, 6, 7, 6. For the eight poorest states the minimum benefits were \$3, 5, 5, 4, 4, 2, 3, 3. The maximum benefits provided ranged from \$20 per week in 4 states to \$15 in 26 states.¹⁰ Table 4 shows the average payments in different states.

The benefits in the lower ranges are insufficient, particularly for workers with low wages who cannot qualify for the maximum compensation.

In spite of the fact that special assistance benefits (for the needy aged, dependent children, and the blind) are the type of expenditure for which the states receive grants from the federal government covering

⁹ Social Security Board, *Social Security Yearbook for the Calendar Year 1941* (Washington, June 1942) pp. 215-216. See also National Resources Planning Board, *Security, Work, and Relief Policies*, Report of the Committee on Long-range Work and Relief Policies (Washington, 1942), and Arthur J. Altmeyer, "War and Postwar Problems," *War and Postwar Social Security*, American Council on Public Affairs (Washington, 1942), p. 23.

¹⁰ Social Security Board, *Significant Provisions of State Unemployment Compensation Laws*, February 18, 1943, I.S.C. 57, Release.

TABLE 4. Average Weekly Total Unemployment Compensation Payments in 1941

Average Payments	No. of States in Class *
\$5.00 and under \$7.00	2
7.00 " " 9.00	13
9.00 " " 11.00	17
11.00 " " 13.00	14
13.00 " " 15.00	5
	<hr/> 51 *

Lowest average, North Carolina—\$5.90

Highest average, California—\$14.57

National average—\$11.06

Source: Social Security Board, *Social Security Yearbook for the Calendar Year 1941* (Washington, June 1942), p. 212, Table 35.

* Including Hawaii, Alaska, and the District of Columbia.

a substantial share of the cost, the level of payments in a large number of states falls far short of being adequate. In the case of general relief—for which no federal assistance is provided—the deficiencies are even more serious.

Average monthly payments to recipients of public assistance for the nation as a whole, in June, 1942, were as follows:

Old-age assistance (per recipient)	\$21.83 ¹¹
Aid to dependent children (per family)	34.01 ¹¹
Aid to the blind (per recipient)	24.37 ¹¹
Aid to persons on general relief (December, 1941) (per case)	24.41 ¹²

These amounts are not sufficient to allow their recipients anything above a bare subsistence. An examination of the payments made in individual states is even more striking. Table 5 reveals that average

¹¹ Social Security Board, *7th Annual Report* (Washington, 1942), p. 80, Table 11.

¹² Social Security Board, *Social Security Yearbook 1941* (Washington, 1942), p. 242, Table 8.

monthly benefits to recipients of general relief were less than \$15 in 16 of the states. The situation with regard to old-age assistance and aid to the blind was only slightly better.

TABLE 5. Average Monthly Payments of Public Aid in June 1942

		Number of States			
Monthly Payments		Old-age Assistance (per recipient)	Aid to Dependent Children (per family)	Aid to the Blind (per recipient)	General Relief * (per case)
Under \$5		—	—	—	1
5 and	10	6	—	2	7
10 "	15	9	1	5	8
15 "	20	9	4	6	13
20 "	25	15	6	18	10
25 "	30	6	5	8	5
30 "	35	5	15	3	1
35 "	40	1	4	1	2
40 "	45	—	4	—	—
45 "	50	—	4	1	—
50 "	55	—	2	—	—
55 "	60	—	2	—	—
		51	47 †	44 †	47 †
National average		\$21.83	\$34.01	\$24.37	\$24.41
Lowest state		Vt. \$7.09	Ark. \$14.32	Ark. \$9.63	Miss. \$3.45
Highest state		Calif. \$36.47	Mass. \$56.12	Calif. \$46.87	N.Y. \$39.31

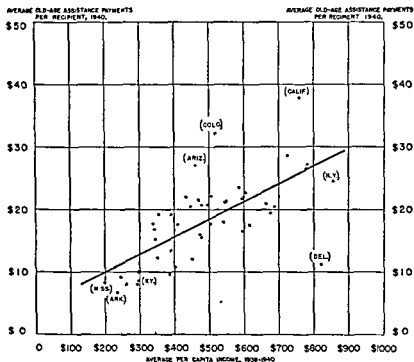
Source: Social Security Board, 7th Annual Report (Washington, 1942), pp. 80-81, Table 11.

* For December 1941. Source: Social Security Board, Social Security Yearbook 1941, p. 242, Table 8.

† Data for several states not available.

As with education and health, so also the levels of public-assistance payments correlate directly with per capita income within the various states. Chart III, showing average old-age assistance payments per recipient, reveals the familiar pattern. Average payments per recipient under the programs of aid to dependent children and aid to the blind within the various states similarly show their direct dependence on economic resources. Those of the eight richest states with a program of aid to dependent children paid average benefits (in June, 1942) ranging from \$56.12 per family in one state to \$31.82 in another.

CHART III
Old age Assistance Levels Related to Economic Capacity



Sources: Old-age assistance payments. *Social Security Yearbook* 1940, pp. 276-277, Tables 5 and 6.

Income payments. *Survey of Current Business*, July 1942, pp. 23-26.

The range among the eight poorest states was from \$22.61 to \$14.32.¹³ There are wide discrepancies among the states also in the average payment per case for general relief. In December, 1941, for example, average relief payments per case ranged from \$39.31 in New York and \$38.16 in Rhode Island to \$6.01 in Arkansas and \$3.45 in Mississippi.¹⁴

A survey of expenditures for relief, family and child welfare, and health activities in 34 important urban areas, made by the Children's Bureau of the Department of Labor,¹⁵ revealed extreme variations in the levels of services provided. Per capita net expenditures (i.e., excluding payments by persons receiving service) in 1940 ranged from \$52.86 to \$13.32. These 34 cities grouped by regions show that the average per capita disbursements for relief, welfare, and health services for cities in the South were one third below the average for all areas. When the urban areas are grouped by a "level-of-living" index,¹⁶ it is not

TABLE 6 Per Capita Expenditures from Public Funds for Relief and Welfare Purposes, in 34 Urban Areas, Grouped by Level of Living

Level-of-Living Groups	Total	Local	State	Federal
Highest fourth	\$32.77	\$10.89	\$7.82	\$14.06
Second fourth	32.63	9.76	5.36	17.51
Third fourth	24.03	6.61	4.93	12.49
Lowest fourth	21.62	4.48	3.55	13.59
Total, 34 areas	\$28.64	\$ 8.40	\$5.71	\$14.53

Source: U. S. Department of Labor, Children's Bureau, *The Community Welfare Picture in 34 Urban Areas, 1940* (Washington, 1941), p. 20.

surprising to observe that the local public authorities in the poorest areas spent less than others for relief, welfare, and health services, while the amount spent increased progressively at higher levels of living. Thus, the per capita expenditure from local public funds was only \$4.48 in the lowest group compared with \$10.89 in the highest.

¹³ Social Security Board, *7th Annual Report, 1942*, p. 80, Table 11.

¹⁴ Social Security Board, *Social Security Yearbook 1941*, p. 242, Table 8.

¹⁵ U. S. Department of Labor, Children's Bureau, *Community Welfare Picture in 34 Urban Areas, 1940* (Washington, June 1941), pp. 9-11.

¹⁶ "Level of living" for the cities as used in the Children's Bureau study is based on a composite index made up of the following factors: (1) the number of individual income tax returns per 1,000 population (1939), (2) the volume of retail sales per capita, in dollars (1939), (3) the number of passenger automobiles registered per 1,000 population (July 1, 1940), and (4) the number of residence telephones per 1,000 population (January 1, 1940).

group. A similar progression may be observed in state outlays per capita, varying from \$3.55 in the lowest group to \$7.82 in the highest. The per capita expenditures from federal funds showed proportionately less difference between the highest and lowest groups, but followed the same general pattern. Accordingly, the federal expenditures failed to offset the inequalities in local and state expenditures.

TAX EFFORT

The great disparities among areas in the support of essential social services are not due to a lack of interest or of effort on the part of the states and localities that provide the least support. In fact, as shown in Chart IV, the poorest states, in general, put forth a greater effort—in terms of economic capacity—to raise funds for public services than do the richer states. An examination of the ratio of tax collection to income payments, for the richest and poorest states, reveals that on the whole the latter group tax their limited resources to a larger extent than do those with more ample resources. Certainly it cannot be said that services in the poorer areas are inadequate because governments within these areas do not make a sufficient effort to finance them.

The Advisory Committee on Education has pointed out that:

It is to the credit of the states of low financial ability that with few exceptions they rank at the top in the percentage of their income devoted to schools. Nevertheless, they rank at the bottom with respect to the quality of the schooling provided. Although the states having the least ability to support education tend to make the greatest effort in proportion to ability, even with such effort they are unable to support education at anything like the level attained, with less than average effort, by the more able states.¹⁷

The same observation holds, in a general way, for the other social services provided by state and local units of government.

COST OF LIVING

It is sometimes assumed that differences in expenditures for the support of social services are due chiefly to differences in living costs

¹⁷ The Advisory Committee on Education, *op. cit.*, p. 31.

CHART IV

State Effort to Support Services

STATES WITH PER CAPITA INCOMES ABOVE \$600 1938-1940	PER CAPITA INCOME 1938- 1940	PER CAPITA TAX COLLECTIONS FISCAL YEAR 1940-1941 AS PERCENTAGE OF PER CAPITA INCOME, 1940									
		1	2	3	4	5	6	7	8	9	
NEW YORK	853										
DELAWARE	821										
CONNECTICUT	781										
NEVADA	779										
CALIFORNIA	759										
MASSACHUSETTS	723										
NEW JERSEY	688										
RHODE ISLAND	676										
ILLINOIS	662										
MARYLAND	616										
OHIO	604										
STATES WITH PER CAPITA INCOMES BELOW \$400 1938-1940											
KANSAS	594										
WEST VIRGINIA	561										
VIRGINIA	567										
SOUTH DAKOTA	555										
LOUISIANA	553										
NEW MEXICO	545										
NORTH DAKOTA	541										
OKLAHOMA	540										
NORTH CAROLINA	539										
KENTUCKY	526										
TENNESSEE	526										
GEORGIA	523										
SOUTH CAROLINA	523										
ALABAMA	517										
ARKANSAS	516										
MISSISSIPPI	519										

as between the various regions of the country. There are, of course, differences in cost as between urban and rural sections. As between cities, however, it is important to avoid confusing (a) geographic differences in *standards* (or *levels*) of living with (b) geographic differences in the *costs of identical goods*. In areas where the average income is small the average standard of living will generally be low also, since income determines the standard of living which may be achieved. This does not mean, however, that the costs of purchasing the same quantity and quality of food, clothing, housing, and other necessities of life differ widely from state to state, or in proportions similar to differences in income.

Studies of costs of living do not indicate that there are large and clearly defined differences between one region, state, or community and another in the *costs of identical or equivalent goods*.¹⁸ A study,¹⁹ whose purpose it was to ascertain the annual costs of self-support for a four-person family in 59 cities of various sizes (but all over 25,000 population) and in various geographic sections, revealed a relatively small spread between the highest and lowest income required for either a "maintenance" or an "emergency level" of living. The annual cost of living at the "maintenance level" in 1935 ranged from \$1,414.54 in Washington, D.C., to \$1,129.81 in Mobile, Alabama, or a spread of less than \$300. The average for the 59 cities was \$1,261. The lowest "emergency level" cost in any city was over \$800 and the highest under \$1,020. Grouping by size of city produces a still smaller divergence.²⁰

A study was made by the Bureau of Labor Statistics²¹ to ascertain what differences, if any, exist between northern and southern cities of approximately the same size in expenditures necessary to maintain the same level of living. The survey covered five northern and five southern cities with populations ranging from 10,000 to 19,000 per-

¹⁸ Daniel S. Gerig, Jr., "The Financial Participation of the Federal Government in State Welfare Programs," *Social Security Bulletin*, Vol. 3 (January 1940), p. 28.

¹⁹ Works Progress Administration, Division of Social Research, *Intercity Differences in Costs of Living in March 1935, 59 Cities*, Research Monograph XII (Washington, 1937).

²⁰ Food costs were especially uniform. Extreme deviation from the average at either maintenance or emergency level was less than 10 per cent. The widest variation was in rent.

²¹ "Differences in Living Costs in Northern and Southern Cities," *Monthly Labor Review*, Vol. 49 (July 1939), pp. 22-38.

TABLE 7 State and Local Efforts to Support Services *

States with Per Capita In- comes (1938-40) above \$600	Per Capita State Tax Revenues as Per Cent of Per Capita In- come, 1941	State and Local Tax Revenues as Per Cent of State In- come Payments	
		1932	1941
N Y	5.1	9.0	12.8
Del	5.2	8.8	7.1
Conn.	4.9	9.0	10.8
Nev	5.2	11.9	12.3
Calif	6.6	10.1	12.0
Mass.	5.1	9.0	11.9
N J	4.8	10.8	13.0
R I	5.3	7.8	11.2
Ill	5.0	8.6	11.1
Md	5.1	8.1	10.0
Ohio	6.7	10.2	11.2
States with Per Capita In- comes (1938-40) below \$400			
Kan	6.1	13.5	15.1
W Va.	7.8	11.1	11.2
Va.	6.0	9.7	9.8
S Dak.	7.3	17.0	16.9
La.	9.8	11.4	15.0
N. Mex.	9.6	11.9	12.7
N Dak.	6.8	18.0	14.7
Okla	7.6	11.2	12.7
N C.	8.8	13.4	13.5
Ky	6.7	10.0	10.8
Tenn.	5.9	11.1	11.9
Ga.	6.1	10.6	10.7
S C.	7.5	13.1	12.4
Ala.	8.2	9.9	12.3
Ark.	7.7	10.8	10.8
Miss.	7.5	17.3	14.0

Sources: Income payments U. S. Department of Commerce, *Survey of Current Business*, July 1942, pp. 23-25.

Tax revenues U. S. Bureau of the Census, *Financing Federal, State, and Local Governments 1941* (September 1942), pp. 114-122.

Population *Statistical Abstract of the United States, 1941*, pp. 4-5, 10.

* Tax revenues are of fiscal years. Income payments are of the preceding calendar year.

sons—all independent industrial communities. It was found that during December, 1938, the cost of living²² in the five small southern cities surveyed was only 3.1 per cent lower on the average than in the five northern cities of the same size. Moreover, the difference of 3.1 per cent in living costs between the northern cities as a group and the southern cities as a group was smaller than the differences between some of the cities in the same region. The lowest as well as the highest cost in the 10 cities surveyed was found in the northern group.

TABLE 8. Index of Living Costs of Wage Earners in 10 Small Cities, December 15, 1938 (average for the 10 cities = 100)

City and Population		Index of Total Cost
Northern cities:		101.6
Chillicothe, Ohio	(18,340)	103.5
Dover, N.H.	(13,573)	109.2
Hanover, Pa.	(11,805)	94.6
Holland, Mich.	(14,346)	96.7
Little Falls, N.Y.	(11,105)	103.9
Southern cities:		98.4
Hattiesburg, Miss.	(18,601)	97.9
Sherman, Tex.	(15,713)	95.0
Statesville, N.C.	(10,490)	102.0
Sumter, S.C.	(11,780)	99.8
Thomasville, N.C.	(10,090)	97.2

Source: "Differences in Living Costs in Northern and Southern Cities," *Monthly Labor Review*, Vol. 49 (July 1939), pp. 23-24

Certainly, there is no basis for assuming that substantially smaller dollar expenditures on social services in the states with low per capita incomes will provide levels of adequacy comparable to those in higher-income states.²³ The marked differences in expenditures for the support of essential services as between the various states are due to neither lack of interest and effort on the part of the units that provide the least support nor in any substantial measure to differences in

²² As shown by indices representing averages obtained from making two separate comparisons, one based upon northern consumption, the other based upon southern consumption.

²³ To some degree it is true that the cost of certain social services (education, for example) is lower in the South owing to lower levels of wages and salaries. Yet these differences are likely in large measure to reflect also differences in the quality and efficiency of the services rendered.

costs. We are left with the conclusion that it is fiscal incapacity which prevents many states and localities from providing for their residents adequate educational and health facilities and adequate protection against financial distress. It is the fiscal incapacity of various areas of the nation which negates, in part at least, the democratic ideal of providing for all individuals a reasonable approach to equality of opportunity and to essential public services. In a country with such widely divergent conditions as prevail in the United States, it is neither possible nor desirable to demand complete equality. It is, however, highly important to eliminate such gross disparity as now exists. The differentials are far too wide. The irreducible minimum, which ought to be made available to every American citizen no matter where he lives, has hitherto not been achieved.

Chapter Three

STATE AND LOCAL TAX DEFECTS

REGRESSIVE CHARACTER OF STATE AND LOCAL TAXATION

It is a widely accepted ideal that the burdens involved in financing public services should be distributed equitably. Generally acknowledged also is the fact that "taxation according to income is the most effective instrument yet devised to obtain just contribution from those best able to bear and to avoid placing onerous burdens upon the mass of our population."¹ More concretely, taxation according to ability to pay means that persons with higher incomes should pay more than a proportional amount in taxes; a progressive tax structure should be the goal.

Judged by this standard, state and local taxes are a far cry from the ideal. In aggregate they bear most heavily on those least able to pay. This follows from the fact that the great bulk of state and local taxes fall directly or indirectly on everyday items of consumption.

Persons with small incomes must necessarily spend a larger proportion of their incomes on the necessities of life than do wealthier individuals. An estimate made by the Office of Price Administration, presented in Table 9, shows that in 1942 families in the \$1,000-\$1,500 income class spent practically all their earnings on consumption, while those with incomes of less than \$1,000 consumed even more than they earned. On the other end of the scale, families in the top bracket consumed on an average only a third of their incomes. Taxes on consumption, then, do not reach the greater part of large incomes at all, while they take something out of every dollar received by a lower-income family.

It is difficult to determine, with any accuracy, the incidence of certain types of taxes; that is, where the burden ultimately rests.² We

¹ President Roosevelt's Message to Congress, June 19, 1935, *Hearings on the Revenue Act of 1935*, U. S. Senate Committee on Finance, 74th Congress, 1st Session, July 30, 1935, p. 2.

² This subject has received considerable attention from economists, but the results have been rather meager. Theoretically it is possible to determine the

TABLE 9 Average Family Consumption as a Percentage of Money Income, by Income Groups, 1942

Income Level	Average Money Income Per Family	Average Outlay on Consumption Per Family	Consumption as Percentage of Average Income
Under \$500	\$ 329	\$ 439	133.4
\$500-1,000	757	791	104.4
1,000-1,500	1,252	1,223	97.8
1,500-2,000	1,744	1,538	88.2
2,000-2,500	2,235	1,868	83.6
2,500-3,000	2,739	2,182	79.7
3,000-4,000	3,458	2,602	75.2
4,000-5,000	4,447	3,145	70.7
5,000-7,500	6,216	3,933	63.2
7,500-10,000	8,260	4,544	55.0
10,000 and over	21,172	7,074	33.4
All levels	\$2,796	\$1,970	70.5

Source: Office of Price Administration, Division of Research, *Civilian Spending and Saving 1941 and 1942* (March 1, 1943), p. 24, Table 13.

know, however, that a tax levied directly on items of consumption—whether they be food, tobacco, admissions, automobiles, or homes—will, under most circumstances, rest in largest part on the ultimate consumer. This means, except for luxury articles, that such a tax places a heavier burden on the lower-income groups than on the well to do, or to put it another way, the tax burden represents a diminishing percentage of income the farther one moves up the income scale.

Taxes falling directly on consumption loom large in the state and extent to which a given tax can be shifted. The analysis of the problem runs, however, in terms of the shapes of demand and cost curves, pricing practices, the intensity of competition, and so on. Actually these data are very seldom available, and, therefore, satisfactory conclusions cannot be reached. Empirical studies of tax shifting are quite difficult, because prices constantly change and the isolation of the effects of the tax is hardly possible, except in a few particularly favorable special cases. On the whole it appears that after a sufficiently long period of adjustment, consumption taxes are likely to be shifted in the form of higher prices, particularly in times of high business activity. Thus consumption taxes impose more than a proportional burden on the low income groups. For a discussion of this problem see Edwin R. A. Seligman, *The Shifting and Incidence of Taxation* (Columbia University Press, New York, 1927, 5th Ed.), John F. Due, *The Theory of Incidence of Sales Taxation* (Crown Press, New York, 1942), and Otto von Mering, *The Shifting and Incidence of Taxation* (The Blakiston Co., Philadelphia, 1942).

local tax structures. These include the bulk of general sales taxes, gasoline and motor-vehicle taxes,³ alcohol, tobacco, and other commodity taxes, and property taxes on residential real estate. Sales taxes and motor-vehicle licenses have made up the bulk of state tax revenues in recent years, as shown in Table 10. The relative burden of consumption taxes, however, is far heavier in certain areas of the country than

TABLE 10. The Weight of State Sales Taxes and Motor-Vehicle Licenses 1931-41

Fiscal Year Ending	Total State Tax Collections *	Sales Taxes †	Motor- Vehicle Licenses	Sales Taxes and Motor- Vehicle Licenses as Per- centages of Total State Tax Collections	
				Incl. Payroll Taxes	Excl. Payroll Taxes
				<i>(in millions of dollars)</i>	
1931	1,991.9	537.5	328.2	43.5	
1932	1,851.1	560.4	310.1	47.0	
1933	1,672.0	550.0	279.9	49.7	
1934	1,909.0	805.6	291.4	57.5	
1935	2,059.3	964.0	295.1	61.1	
1936	2,558.5	1,228.6	338.0	61.2	61.7
1937	3,262.2	1,405.6	371.6	54.5	60.6
1938	3,865.3	1,507.9	378.9	48.8	60.4
1939	3,851.3	1,530.4	387.8	49.8	62.7
1940	4,117.8	1,692.2	414.5	51.2	64.4
1941	4,453.7	1,872.9	460.7	52.4	65.3

Source. Tax Institute, *Tax Yields 1940*, pp. 44 and 114, and 1941, p. 46. All data apply to the 48 states only.

* Includes payroll taxes.

† Includes taxes on alcoholic beverages, admissions, gasoline, general sales, oleomargarine, soft drinks and tobacco.

in others. Sales taxes as a percentage of total tax collections within the various states in the fiscal year ending 1941, for example, ranged from 71 per cent in South Dakota and 69 per cent in Mississippi to some 21 per cent in New Jersey, 23 per cent in Rhode Island, and 24 per cent in Massachusetts.⁴

³ The taxes paid by trucks, buses, taxicabs, and motor passenger cars used for business purposes can be shifted to consumers, through higher prices. This is true also of the general sales taxes and certain property taxes.

⁴ Total tax collections include payroll taxes. The definition of sales taxes is given in Table 10. The computations were made on the basis of data given in Tax Institute, *Tax Yields 1941*.

The ultimate burden of business taxes—that is, the directions in which various business taxes are shifted—is likewise not an easy thing to determine. Both theoretical and inductive studies, however, suggest the validity of the conclusion that taxes upon the net income of corporations will, under most circumstances, be borne by the stockholders to a very much larger extent than will business taxes not related to net income. Those not so related can more easily be treated as costs and are thus shifted to the ultimate purchaser.⁵ While federal taxes on business are made up almost entirely of corporate net-income and excess-profits taxes, the bulk of state business taxes are levied on the basis of gross receipts, licenses, franchises, mileage, or flat-rate taxes. In 1940-41, for example, state corporate net income taxes yielded only \$190 million (or 4.2 per cent of total tax collections), while taxes on specific businesses amounted to \$519 million (or 11.5 per cent of total tax collections).⁶ State business taxes are, accordingly, mainly of the type that tend to be shifted to the consumer. When one adds these business taxes to sales taxes and other forms of state consumption taxes, it is clear that state tax structures are highly regressive in character.

With respect to the local governmental units within the states, almost the entire weight of taxation falls on property. In 1940-41, for example, property taxes comprised 92 per cent of total local tax collections. The extent to which a property tax is shifted, capitalized, or borne by the present taxpayer depends on many conditions. The extent to which it is shifted will determine whether it will rest on the tenant or on the present owner or whether it has already been absorbed by a former owner. In the case of business property, the degree and direction of shifting will determine the amount of the tax absorbed in lower rents or profits, lower wages, or in higher prices for the goods and services produced. About one-third to one half of all real-property taxes are imposed on residential real estate. A very large part of the taxation of residential housing is borne by owner-occupiers and tenants and therefore amounts to a specific tax on an important item of consumption, namely housing (and the smaller the income of a family the

⁵ This does not mean that no part of corporate income taxes are shifted to consumers nor that no part of the other business taxes are absorbed by the sellers. It is merely a question of the relative ease in shifting taxes forward to the ultimate consumer.

⁶ U. S. Bureau of the Census, *Financing Federal, State and Local Governments 1941* (Washington, September 1942), p. 22.

larger is the proportion of the income spent for housing). Moreover, as we have seen, a large share of the local taxes on business property is shifted to the ultimate consumers and becomes, likewise, a burden on consumption.

Even at the state level, as noted above, taxes related directly to individual ability to pay make up only a small part of total tax collections. Income, inheritance, and estate taxes (resting on the two best criteria of ability to pay—net income and transfer of property at death—and offering the best opportunity to apply graduated rates on the ability principle) comprised only 12 per cent of total state tax revenue in 1940-41. In comparison, net income and death-transfer taxes comprised almost one-half of total federal tax collections in the fiscal year ending 1941.⁷

Since the great bulk of state and local taxes are unrelated to individual net income, they hit especially hard those whose incomes fall either through personal misfortune or through business conditions. Depression brings an avalanche of property-tax delinquencies and forced sales, and many people are forced to eat into their meager savings in order to meet their state and local taxes. An inequitable tax structure becomes especially oppressive in bad times.⁸

A picture of the manner in which the federal, state, and local governments were financing public services before we actively entered the war is presented in Table 11.

A recent investigation which attempted to measure the distribution of the tax burden among people of various income brackets made more explicit a widely known fact—namely, that the state and local tax structures were not progressive (and were, in fact, regressive at the lower-income ranges), while the federal structure, although regressive for incomes below \$500 and proportional for incomes up to \$5,000, had an important element of progression, which was substantial in the higher-income brackets.

Certainly the burden of financing state and local services cannot be

⁷ U. S. Bureau of the Census, Division of State and Local Government, *Financing Federal, State, and Local Governments 1941* (Washington, September 1942), pp. 34-35.

⁸ Another element of inequity is introduced by the large amount of double taxation as between states. For example, a good many individuals are now subject to income tax by the state in which they earn income, or from which their income is derived, and also by the state of domicile.

TABLE 11 Federal, State, and Local Revenues

Fiscal Year Ending in 1941

Source	State & Local		Federal	
	(millions of dollars)	Per cent	(millions of dollars)	Per cent
Tax revenue				
Individual income	235	2.3	1,418	17.2
Inheritance, estate, and gift	122	1.2	407	4.9
Corporate income	192	1.9	2,053	24.8
Specific businesses	698	6.8	193	2.3
Sales, motor vehicle licenses, customs & misc excises	2,368	23.2	2,726	32.9
Payroll	906	8.9	993	12.0
Property	4,474	43.8	—	—
Miscellaneous taxes	110	1.1	28	0.3
Nontax revenues (service charges, etc.)	1,109	10.8	464	5.6
Total revenues from own sources	10,213	100.0	8,282	100.0
Aid from the federal government	840 *		840 †	
Revenues for own purposes	11,053		7,442	

Source U S Bureau of the Census, Division of State and Local Government, *Financing Federal, State, and Local Governments 1941* (Washington, September 1942), p. 22

* Includes \$169 million for highways and \$332 million for public assistance.

† In addition \$11 million were granted to territories and island possessions, leaving \$7,431,000,000 of federal revenues for own purposes.

said to be equitably distributed. The federal tax structure, although by no means wholly progressive, applies the ability principle more extensively, and therefore approaches the ideal much more closely. At all levels of government, however, much remains to be done before the burdens involved in financing public services are equitably distributed.

Regressive taxes are not only inequitable in that they violate the principle of ability to pay, but they are also repressive on employment and business activity since they tend to reduce the volume of mass-consumption expenditures. We shall have more to say about this later, but at this point it is sufficient to note that while all taxes are necessarily more or less restrictive, consumption taxes are particularly so.

TAX OBSTACLES TO INTERSTATE BUSINESS

Public finance is a potent weapon. The spending, taxing, and borrowing activities of governmental units can be managed so that they

TABLE 12. Taxes as Percentages of Consumer Income
1938-39

Income Class	Federal	State & Local	Total
Under \$500	7.9	14.0	21.9
500-1,000	6.6	11.4	18.0
1,000-1,500	6.4	10.9	17.3
1,500-2,000	6.6	11.2	17.8
2,000-3,000	6.4	11.1	17.5
3,000-5,000	7.0	10.6	17.6
5,000-10,000	8.4	9.5	17.9
10,000-15,000	14.9	10.6	25.5
15,000-20,000	19.8	11.9	31.7
20,000 and over	27.2	10.6	37.8
Total	9.2	11.0	20.2

Source: Gerhard Colm and Helen Tarasov, *Who Pays the Taxes?* Temporary National Economic Committee, Monograph No. 3 (Washington, 1940), p. 6, Table 1. Although the study is frankly experimental and tentative, the assumptions and methods used are essentially sound, and the results can be considered reliable within broad categories. Subsequent revision of this study (without a breakdown into federal, state and local categories) published by Helen Tarasov in *Who Does Pay the Taxes?* (Social Research Supplement IV, 1942, p. 6, Table 1) has not revealed significant changes.

can make a distinct and important contribution to the expansion and stability of the national economy. But these activities of government may also be mismanaged so as to cause contraction and instability. A co-ordinated and rational fiscal policy at all levels of government is urgently needed.

The fact that state and local expenditures amounted to between 10 and 15 per cent of the national income and more than 50 per cent of total public expenditures in the decade before the war bears striking witness to the significance of nonfederal fiscal activities. An analysis of such activities, however, reveals not only that serious tax obstruction to interstate business has been set up, but also that the contribution of state and local finance to the progress of the economy has not infrequently been negative.

The expansion of our American economy has in no small degree resulted from the free flow of interstate trade and the development of a great nation-wide market which has enabled private enterprise to carry on business in all parts of the country. It is of serious import, then, that states and localities have erected tax barriers to interstate

commerce and have unduly burdened interstate concerns. The desire for protection (i.e., the attempt to preserve home markets for home products) has predominated in certain tax measures, while the ever propelling search for funds has been the motive force in other cases. Conflict between the requirements of a free national market and the character of state and local taxes has reached serious proportions.

TRADE BARRIERS

Many state and local tax laws have been enacted which tend to prevent goods and services from moving freely between the various communities of the country. Among these are several important commodity trade barriers. In the case of alcoholic beverages, tax discriminations and retaliations flourish, with far-reaching effects on interstate commerce. Some states extend preferential treatment to locally produced alcoholic beverages by means of license fees and excise tax differentials, and by means of merchandising restrictions. No fewer than 27 states have laws giving special aid to wine produced within their borders or wine containing state-grown grapes. Twenty-four states similarly aid the beer industry, and 16 states assist resident distillers of hard liquor.*

A large number of states have placed tax restrictions upon oleomargarine. States in which dairy interests are strong have imposed heavy excise and license taxes intended to provide a "protective tariff" for butter. On the other hand, states in which raw materials for margarine are produced discriminate against margarines not made exclusively from cottonseed oil, animal fat, or whatever the home-produced fats or oils may be. Some 30 states attempt to limit the sale of margarine within their borders in order to protect home producers.

Tax barriers to highway commerce are frequent. Interstate trucking and bus transportation are burdened with multiple and discriminatory taxation. Heavy registration fees, ton mile taxes, "port-of-entry" deposits and surety bonds, special licenses and other costs have frustrated many attempts to ship goods by truck through certain states or to do business by means of merchant trucking.

* "The State of Maine levies a license fee of \$3,000 on distillers, brewers, or wineries using exclusively out-of-state agricultural products, although the license fee for the user of exclusively Maine farm products is but \$100. If both Maine and out-of-state products are used, the license fee is proportionate to the

Trade barriers, generally, make the transaction of business more costly and less efficient; or they divert the flow of commerce away from its natural channels. Similar in effect are other discriminatory taxes, of which chain-store taxes are an outstanding example. The philosophy here also is "protectionist," embracing the attempt to improve the position of a particular group, not through the method of improving the operating efficiency of that group, but rather by means of handicaps placed upon certain competitors.

Insurance companies are victims of the desire to foster home industry. A large number of states impose discriminatory taxes against "foreign" life or fire insurance companies.¹⁰ In certain cases, these are in the form of discriminatory premium taxes on those insurance companies doing business within the state which do not have a given proportion of their assets invested within the state. Some of the discriminatory features of state insurance taxation, however, are minimized through reciprocity or through the threat of retaliation.

BURDENS ON INTERSTATE CONCERNS

In their desire to maximize revenues, states often place an undue burden on interstate businesses. It is natural that allocation formulas used for determining the income earned by interstate concerns within a given state should be devised so as to maximize the revenue of the taxing state. A large variety of factors are used to determine the local share of interstate business. The result is that the combined base upon which the various states levy taxes is often well over 100 per cent of the total income of an interstate concern. In Table 13 are presented current state practices in allocating income of mercantile and manufacturing corporations for income-tax purposes. Fortunately the Massachusetts formula, which has much to recommend it, is also the one most commonly used.

Not only do the statutory allocation formulas employ a variety of bases, but in many cases the tax administrator is given wide discretion in the use of the formula, so that he may be able to manipulate it to maxi-

quantity and source of the raw materials" F. E. Melder, *State Trade Walls*, Public Affairs Pamphlets, No. 37 (New York, 1933), p. 20.

¹⁰ Council of State Governments, *Book of the States, 1939-40* (Chicago, 1939), p. 123; "Tax Barriers to Trade," *Tax Institute Symposium* (Philadelphia, 1940); *Federal, State, and Local Government Fiscal Relations*, Senate Document No. 69, p. 252.

TABLE 13 Allocation of Business Income for State Corporate Income-Tax Purposes

Factors Used by the Various States in Determining Income Earned within the State (i.e., used as allocation fractions) *	Number of States Employing the Various Combinations of Factors in Their Allocation Formulas †	
(A) Gross receipts (or sales)	A	1
(B) Tangible property	A or D	1
(C) Payroll	A or E	1
(D) Manufacturing costs	A + B	5
(E) "Business" done	A + B + C	11
(F) Purchases of goods, materials, etc.	A + B + C + F	1
(G) Cost value of capital assets	A + B + D	8
(H) Accounts receivable	A + D + G	1
(J) Stock of other corporations	E	1
(K) Net sales cost	B + H + J	2
	C + G, or K	1

Source Tax Research Foundation, *Tax Systems* (9th Ed., Chicago, January 1942), pp. 146-151

* For example, $\frac{\text{Gross receipts within state}}{\text{Total gross receipts}}$.

† The most commonly employed formula is the so-called Massachusetts formula (A + B + C above). The allocation fraction is determined as follows:

$$\frac{\text{Average value of tangible property within state}}{\text{Average value of total tangible property}} + \frac{\text{Wages, salaries or other compensation to employees within state}}{\text{Total wages, salaries or other compensation to employees}} + \frac{\text{Gross receipts within state}}{\text{Total gross receipts}} \div 3$$

Total net income of a corporation is multiplied by the allocation fraction to determine amount of income arising from sources within the state.

mize the share going to the taxing state. It is inevitable under this procedure that many interstate firms bear an unduly heavy tax burden and, to that extent, are placed at a competitive disadvantage as against intra-state business.

THE CHAOS IN BUSINESS TAXATION

Business taxes in the states are a conglomeration of heterogeneous taxes imposed for different purposes, on different bases, under many forms of rate schedules, and with many types of administrative machinery. They are characterized, in general, by arbitrariness, complexity, and lack of co-ordination. Businesses are subject not only to property

taxes, net income taxes, excise taxes, sales taxes, capital-stock taxes, and severance taxes, but also to a great variety of special charges, including privilege, license, and occupation taxes.

Worthy of special notice for their arbitrariness are the so-called occupation taxes, used in a number of states, particularly in the South. A few of them are based upon some rough measure of the volume of business, but most of them are based upon no reasonable principle whatever. Mr. Arant¹¹ lists no less than 11 external indices that are used either singly or in combination to form the base or measure of many of these taxes. They are:

1. the occupation itself (e.g. Florida taxes cotton buyers \$100 per year, coffin manufacturers \$50 per year, dealers in alligators \$10 per year, etc.);
2. the population of the community in which the business operates (e.g. Alabama taxes abstract companies. . . .

\$50	per year	if located in municipalities with population of 20,000 or more
\$25	" " " " " "	" " " 10,000 to 20,000
\$10	" " " " " "	" " " 5,000 to 10,000
\$ 5	" " " " " "	" " " less than 5,000);
3. the kind or size of product produced or sold (e.g. Florida taxes boat-builders contracting for building boats of more than 25 tons—\$25 per year; boatbuilders contracting for building boats of between 10 & 25 tons—\$10 per year);
4. the number of units of some essential equipment (e.g. Mississippi taxes knitting mills where the number of knitting machines is more than

500	\$150 per year
400-500	\$125 per year
200-400	\$100 per year, and so on down to 50 or less at \$10 per year);
5. the room or producing capacity of building or factory;
6. the number of employees (e.g. Tennessee taxes automobile repair shops

\$ 5	per year	if hiring 2 men or less
\$10	" " " "	3- 5 men
\$20	" " " "	5-10 "
\$40	" " " "	10-20 "
\$60	" " " "	20 and more men);

¹¹ Roscoe Arant, "Business Taxation in the Southern States," *The Tax Magazine*, Vol. 16, 1938. (By permission of Commerce Clearing House Inc.)

7. the kind or size of equipment;
8. the length of time or number of local jurisdictions in which business is carried on (e.g. Florida taxes advertising agencies \$45 per year if they have signs or billboards in 10 counties or less, and \$200 per year if they have signs or billboards in more than 10 counties);
9. the volume of actual production (e.g. Mississippi taxes cotton compresses by the number of bales compressed per annum, ranging from \$1,000 per year if more than 100,000 bales are compressed within the year, to \$100 per year if 10,000 bales or less are compressed);
10. the amount of fee or price charged (e.g. Georgia taxes athletic clubs \$50 where admission charges are \$50 to \$1 00, \$100 where charges are \$1 00 to \$1 50, \$200 where charges are \$1 50 or over),
11. the amount of invested capital

Only a little less arbitrary than the occupation taxes are the capital-stock taxes, now used in most of the states. They are characterized by a great variety of bases, procedures, and methods of apportionment. The accurate valuation of capital stock has proved to be a well-nigh insuperable administrative problem. The par value or any other assumed value may be far from a fair value of the stock. Moreover, capital stock alone without regard to bonds or other indebtedness gives a distorted picture of the capital of a corporation. Serious inequalities in the levy of capital stock taxes are inevitable.

Franchise taxes are another method of making corporations pay for their "special privileges." The value of the franchise is measured in several ways with reference to such factors as net income, capital stock, or the value of property or the volume of business in the state. Here, too, considerable diversity arises in the methods of taxation, and both principles and practice in the levy of franchise taxes appear to be confusing and inconsistent.

In spite of their wide variety, state taxes on specific businesses (income tax excluded) yield relatively little revenue. In fiscal 1941, for example, they yielded only about \$500 million and accounted for only a little over 11 per cent of total state tax collections. Their yield certainly does not justify their troublesomeness and the high compliance costs they entail.

The chaotic state tax structures which have resulted from the wild scramble for tax sources increase the difficulty and uncertainty of business planning. This refers not only to the problems of investment planning, but also to cost allocation, dividend policy, and the other

problems involved in programming. Moreover, the costs to business concerns of compliance with state tax laws are extremely high. A study of costs of compliance, or the so-called invisible tax paid by business, was made for the year 1934, based on questionnaire replies from 163 corporations. Out of the sample, 95 corporations paid a federal income tax, with the median corporation having a compliance cost of 4.7 per cent of taxes collected. In contrast, the median corporation of the 76 companies paying state income taxes (or franchise taxes measured by income) for the same year had a compliance cost of 9.5 per cent; and 14 out of the 76 corporations had compliance costs in excess of 40 per cent of collections.

Robert Murray Haig, who conducted the study, writes: "If our sample of corporations is typical of the general situation, an important cause, perhaps the primary cause of the high private costs of tax compliance, is to be found in the barrier set up to the extension of the free trading area of our business concerns by the lack of uniformity in state taxes." Of the 63 corporations that paid state corporation income taxes and furnished detailed information, the typical one-state business had a cost of compliance of 3.5 per cent, whereas among those engaged in business in two or more states, the typical cost was 10.5 per cent. In one case it cost a manufacturer (about 80 per cent of whose business was interstate) \$3,900 to pay state income taxes of \$2,400 to 14 states. In another extreme case, it cost a large retail establishment \$40,000 to pay \$30,500 in miscellaneous unspecified taxes and fees to 28 states.¹²

Thus far, only the most glaring examples of tax obstruction to economic expansion have been discussed. Many other problems arise in connection with tax competition among the states, the burden on construction activities of high and chaotic property taxes, and the pressure on marginal firms of taxes not based upon net earnings—especially in depression. These and other problems are of special import in relation to the secular and cyclical movements of the economy.

¹² Robert Murray Haig, "The Cost to Business Concerns of Compliance with Tax Laws," *The Management Review*, Vol. 24 (November 1935), pp. 328-330. Professor Haig discusses the various factors that distort the figures, and states that "actual contact with the individual returns has led me to the belief that the costs of compliance are understated in more instances than they are exaggerated." *Ibid.*, p. 326.

Chapter Four

FISCAL PERVERSITY IN BOOM AND DEPRESSION

CYCLICAL fluctuations in the private sector of the economy must be expected. Past experience has indicated, however, that sound fiscal policy on the part of government can do much to mitigate the severity of the fluctuations, and to raise the level of economic activity.

A rational fiscal policy requires the control of public expenditures, taxation, and borrowing so as to promote economic stability at continuously high levels of business activity and full employment. Such a program involves at times curtailment of expenditures and an increase in tax revenues in order to check inflation, and at other times it involves an expansionist program in order to prevent deflation and mass unemployment.

There is no probability that the goal of economic stability with continuous high levels of income and full employment can be achieved without a flexible adjustment of public expenditures, taxes, and borrowing. In the prewar years of serious depression and unemployment, an expansionist fiscal policy of a magnitude far greater than any attempted was called for. For some years to come, the war and its aftermath may bring us wholly new conditions. It may well be that under these new conditions we shall for some time have to fight inflation more than deflation. A rational fiscal policy will be prepared to meet either condition. In a period of depression and unemployment, loan expenditures involving the use of public credit are desirable. If, on the other hand, inflation needs to be checked, then extraordinary public expenditures should be curtailed, taxes should be increased, and the public debt reduced.

Under boom and inflationary conditions, public expenditures should be kept at a minimum consistent with the maintenance of essential social services (i.e., those services which are accepted as part of the living standard within the community). Tax rates should be maintained at a high level in such periods in order to drain off excess con-

sumer purchasing power and in order to build up reserves (such as capital-improvement reserves) for future contingencies. Expansionary public borrowing should be eliminated and, if the boom is pronounced, the repayment of public debt should be accelerated. The importance of anti-inflationary policy is evident in the current war period.

In periods of depression, fiscal policy should be directed at increasing consumer purchasing power, and at stimulating investment and business activity generally. To accomplish this, governmental outlays should be expanded, while consumption taxes should be reduced. Such expenditures should be financed through borrowing, through accumulated reserves, and through nonconsumption taxes.

STATE AND LOCAL FINANCE IN THE BUSINESS CYCLE

The taxing, borrowing, and spending activities of the state and local governments collectively have typically run counter to an economically sound fiscal policy. These governmental units have usually followed the swings of the business cycle, from crest to trough, spending and building in prosperity periods and contracting their activities during depression. In the boom of the late twenties, they added to the disposable income of the community, and bid up prices and building costs in large scale construction activities. In the depressed thirties, the fiscal policies of these governments exerted a deflationary rather than an expansionary effect on the economy: expenditures, and especially construction outlays, were severely reduced, borrowing was restricted, and taxes weighing on consumption were substantially increased.

Table 14 reveals the cyclical character of state and local construction activities and "net income-increasing expenditures" (as here calculated, a rough measure of the net additions by governments to the disposable cash income of the community), as well as the sharp increase in sales taxes in the depression period (taxes which weigh most directly and heavily on consumption). The federal government, while following a countercycle expenditure program, followed an indefensible tax policy to the extent that it joined the state and local bodies in raising the level of consumption taxes.

In the current inflationary war period, a number of state and local governments are pursuing sound fiscal policies but some are pursuing

economically unsound policies. Some are yielding to the pressure for increases in expenditures and for reduction of tax rates. Provisions for debt retirement, for the setting aside of reserves, and for the establish-

TABLE 14 Federal, State, and Local Fiscal Policy Indices
1928-39

(in millions of dollars)

Fiscal Year, Ending	Net Income-increasing Expenditures *		Expenditures for New Public Construction, by Source of Funds		Taxes on Sales	
	Federal	State & Local	Federal †	State & Local	Federal ‡	State §
1928	-77	810	188	2,104	1,054	— ¶
1929	-232	928			1,065	— ¶
1930	388	1,221	307	2,469	1,060	— ¶
1931	2,419	1,291	422	2,156	839	538
1932	1,797	676	460	1,334	739	560
1933	1,809	-705	647	707	961	550
1934	3,460	-1,165	1,380	794	1,404	806
1935	3,568	-657	1,234	616	1,573	964
1936	4,374	-450	2,335	881	1,794	1,229
1937	1,114	-244	2,043	845	2,104	1,406
1938	2,225	-321	2,139	1,089	1,935	1,508
1939	3,581	209			1,905	1,530

- Sources 1 Net income increasing expenditures Estimates of Lauchlin Currie, *Temporary National Economic Committee, Hearings*, Part 9 (Washington, May 16, 1939), p 4011, as revised by Haskell Wald.
 2 Estimated expenditures for new public construction National Resources Planning Board, *The Economic Effects of the Federal Public Works Expenditures, 1933-1938*, prepared by J K Galbraith (Washington, November 1940), p 18
 3 Federal sales taxes *Annual Report of the Secretary of the Treasury, 1941* (Washington, 1942), pp 416, 485-486
 4 State sales taxes. Tax Institute, *Tax Yields, 1940* (Philadelphia, 1941), p 44

* The measures employed here are extremely rough, but they serve to give a general picture of trends

† Including work relief

‡ Includes taxes on liquor, tobacco, manufacturers' excise, soft drinks, admissions, oleomargarine, and customs

§ Includes taxes on gasoline, general sales, alcoholic beverages, admissions, oleomargarine, soft drinks, and tobacco.

|| Average for 1925-29.

¶ Not available

ment of "shelves" of public works for postwar construction, are here and there being made. But this action is far from general despite the thoroughly sound resolutions and recommendations of the more important agencies representing state and local officials, such as the Council of State Governments and the Municipal Finance Officers' Association.¹

The intimate connections between income levels and the revenue-raising capacity of governmental units is strikingly revealed in the fluctuations of the business cycle. During the booming twenties, states and localities generally were experiencing operating surpluses. In the depression of the thirties, state and local units, with few exceptions, were in serious financial straits. The devastating effects of business depression on state and local finances can readily be seen from the following: tax collections of all state and local units fell from \$6,798 million in 1930 to \$5,715 million in 1933;² tax delinquency for 150 of the largest cities rose from 10.1 per cent in 1930 to 26.3 per cent in 1933;³ and the proportion of state and local bond sales bearing a rate of interest in excess of 5 per cent rose from 6.5 per cent of total sales in 1930 to 37.9 per cent of sales in 1932.⁴

When the contraction of incomes due to the cyclical downturn is especially severe, state and local governments may face virtual bankruptcy. During the thirties, for example, a substantial number of localities and even some state governments found themselves in a posi-

¹ Several states have explicitly established postwar reserves. Minnesota has set aside funds for highways, school programs, and small-unit housing construction. Rhode Island has established a \$15 million public-assistance reserve fund and appropriated \$2 million to it for the current biennium. See A. B. Jebens, "State Agricultural Legislation in 1942," *Land Policy Review*, U. S. Bureau of Agricultural Economics, June 1942. Some eleven states have legislation authorizing their subdivisions to set aside reserves to finance capital outlays. Ambrose Fuller, *Legislative Authorization for the Creation of Capital Reserves for Future Municipal Outlays*, Series AM—Report 26, of the American Municipal Association (July 1942). In a few instances, planning for postwar public works has been undertaken by specially appointed commissions with sufficient funds to make possible engineering surveys and the blueprinting of projects. Important as these individual instances may be, they are nevertheless superior to the general practices being pursued.

² National Industrial Conference Board, *Economic Record*, Vol. 1, September 15, 1939, p. 96.

³ F. L. Bird, *Trend of Tax Delinquency 1930-1940 in Cities of Over 50,000 Population* (Dun and Bradstreet, 1941), p. 14.

⁴ *State and Municipal Compendium*, Part I, June 30, 1942, p. 8.

tion in which they were forced to slash public services drastically, to default on debts, and in some cases to resort to the practice of printing scrip

It is a striking commentary on the effect of depression on state and local finance that in the trough of the last depression, three states—Arkansas, Louisiana, and South Carolina—were forced to default on their debts, as were 37 large cities (with populations of over 30,000). In a number of states—Michigan, North Carolina, North Dakota, and Kansas—education expenditures from state and local funds declined by over 35 per cent between 1930 and 1934, and other services similarly suffered.

On the other hand, at a high level of national income the financial problems are minimized. In prosperity, tax yields generally swell state and local treasuries. State tax collections, for example, increased by 15.4 per cent between the fiscal years 1941 and 1943. During the same period state corporate net income-tax collections increased by over 98 per cent.⁵ At the same time emergency relief and welfare costs were substantially reduced. The general improvement in state finance within recent years has resulted in substantial budgetary surpluses. New York on June 30, 1943 had an accumulated surplus of \$69 million. California reported a general-fund surplus on August 31, 1943 of \$96 million. Wisconsin reported a general-fund balance, including investment in United States bonds, of \$27 million.⁶ Substantial general-fund surpluses were reported also in Colorado, Connecticut, Illinois, Indiana, Kentucky, Maryland, North Carolina, Oregon, Tennessee, and Virginia. These surpluses have permitted certain of the states to reduce their debts or to create reserve funds for postwar construction.

OBSTACLES TO SOUND FISCAL POLICY IN PROSPERITY

In periods of prosperity, governmental officials tend to share the general optimism and embark on costly expansionary programs. When treasury surpluses appear, strong pressures are applied by special-interest groups to increase the construction of capital works on the one hand, and to reduce tax rates on the other. With respect to the latter, the desire to attract expanding enterprises, and the fear of losing mobile

⁵ See p. 7.

⁶ Congressional Record, 78th Congress, First Session, Vol. 89, No. 154, p. 8477.

manufacturing units, dictates a decrease in tax rates when treasuries are flush.

At the state and local level, it is especially difficult to collect large revenues during prosperity periods. It is easy to yield to pressures for tax reduction; it is difficult to raise tax rates or to impose new taxes. Since tax rates generally cannot be increased, substantial revenue yields—consistent with the need for tempering inflationary pressures and for the accumulation of reserves—could be expected only if progressive income taxes loomed large in the tax structure. As was pointed out previously, however, personal and business income taxes make up but a small part of state and local revenues. Under such circumstances, tax yields in prosperity cannot be expected to reach the desired levels. And obstacles to the setting aside of reserves during periods of prosperity are often present in the form of constitutional and statutory prohibitions against the accumulation of surpluses.

It appears, then, that during periods of prosperity the chief limitations to the pursuance by nonfederal units of a sound financial program are of an institutional character.

LIMITATIONS TO ANTIDEPRESSION POLICY AT THE STATE AND LOCAL LEVEL

In periods of depression, state and local governments are confronted with serious economic as well as institutional obstacles to the carrying out of a countercycle fiscal program. In the face of a strong deflationary movement, most nonfederal units have found it necessary

TABLE 15. State and Local Expenditures *
Selected Fiscal Years Ending in 1929-37

Fiscal Year Ending	(in millions of dollars)		
	Total	State	Local
1929	8,654	1,943	6,711
1933	7,491	2,067	5,424
1934	7,657	2,044	5,613
1937	8,801	2,851	5,950

Source: National Industrial Conference Board, *Economic Record*, Vol. 1, September 15, 1939, p. 94.

* Excluding debt retirement.

to contract their activities. The extent to which expenditures were contracted in the last depression is strikingly illustrated by the trend in public-work outlays. Expenditures for new construction from state and local funds, which averaged \$2,104 million between 1925 and 1929, fell to \$1,334 million in 1932, \$707 million in 1933, and reached a low of \$616 million in 1935. In other fields of state and local activity, reductions in expenditures, although not as drastic generally as in the case of new construction, were substantial.

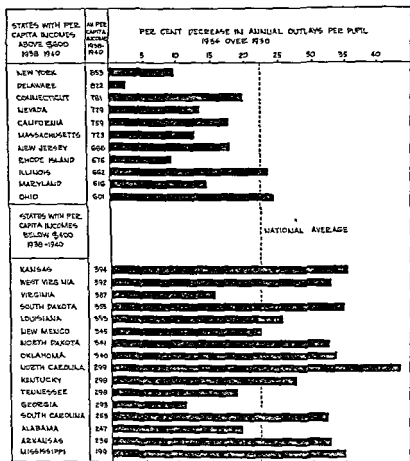
In view of the intimate relationship between the wealth and income of an area and its fiscal capacity, a greater reduction in expenditures during depression periods is likely to occur in the poorer areas of the country than in the richer areas. Such was in fact the case in the depression of the thirties. With respect to educational outlays, we find that the poorer states lowered their expenditures more drastically than did the richer states. Chart V shows the percentage drop in educational expenditures per pupil between 1930 and 1934 for the poorest states (those with per capita incomes—average for 1938-40—of less than \$400) and for the richest states (those with per capita incomes of more than \$600). Whereas only two of the richer states lowered (percentage-wise) their educational expenditures by more than the national average reduction of 22.2 per cent (from 1930 to 1934), the great majority of the poorer states decreased their service levels substantially more than the national percentage average.

The same pattern is found in the other important state and local services. It is evident that the poorer areas of the country cannot finance an adequate level of services from their own resources, nor can they maintain their expenditures in depression. It is in the areas where purchasing power is characteristically at the lowest level that the non-federal units can contribute least to the income flow of the community when such a contribution is most needed, namely, in periods of depression.

The ability of a governmental unit to maintain its expenditures and to add to the disposable income of the community depends fundamentally upon borrowing capacity, availability of reserve funds, ability to obtain funds through taxes which do not reduce substantially the consumption of the community, and grants from a higher level of government.

CHART V

Effect of the Depression upon Education Service Levels



Source. *Statistics of State School Systems, 1937-38, Biennial Survey of Education in the United States, Bulletin 1940, Ch. II, U. S. Office of Education, Table 14.*

MUNICIPAL CREDIT

There are strict limitations on the ability of localities to borrow in periods of depression. Being dependent, in the main, upon banks and other private investors, local units of government can obtain funds only when they can meet the criteria of soundness set up in the municipal security market. "Adequate" security is demanded by investors, and this usually means a favorable economic background, optimum tax collections, a low volume of delinquency, balanced budgets, and self liquidating projects. Because of the character of the municipal market, then, localities can borrow readily and are encouraged to embark on large scale building programs only when their financial positions are favorable. When tax yields shrink and borrowing becomes increasingly necessary in order to maintain service levels, the private market for municipals is restricted. Substantially the same is true of state issues. Table 16 shows the cyclical character into which municipal long term borrowing has been forced.

TABLE 16 Gross and Net Increase in Permanent Municipal Indebtedness

	<i>(in millions of dollars)</i>		
	New Bond Issue	Old Issue Retired	Net Additions to Debt
1928	1,415	456	959
1929	1,431	454	977
1930	1,487	488	999
1931	1,256	506	750
1932	849	526	323
1933	520	546	26 *
1934	939	630	309
1935	1,220	871	343
1936	1,117	786	331
1937	902	794	108
1938	1,100	827	273
1939	1,126	894	232
1940	1,234	968	266

Source: *State and Municipal Compendium*, Part I, June 30, 1942, p. 4.

* Decrease

The history of municipal credit in the last depression serves to illustrate the problem. Local borrowing was at its lowest level in the trough

of the depression. Issues could not be floated at all, or only on onerous terms. In 1932, 697 issues totaling \$260 million could not find a market; in 1933, 528 issues with a dollar volume of \$212 million failed of sale, including sales by such governments as Buffalo, Philadelphia, Cleveland, Toledo, Mississippi, and Montana.

Credit could be obtained, if at all, only under rigorous conditions: short-term maturities, high interest rates, and stiff provisions concerning economies in expenditure, tax-collection procedure, and so on. Table 17 shows the high rates that had to be paid for a large part of the money borrowed by states and localities in the depth of the depression. In 1932, in fact, no less than 78.7 per cent of all state and local issues bore rates of 4.5 per cent and higher.⁷

TABLE 17. Percentage of State and Local Bond Sales Bearing Interest Rates Higher Than 5 Per Cent

1928	7.8
1929	19.6
1930	6.5
1931	6.1
1932	37.9
1933	14.9
1934	5.7
1935	.7

Source *State and Municipal Compendium*, Part I, June 30, 1942, p. 8.

Localities, particularly, found themselves in an unfortunate position. Property values dropped considerably during the depression, as shown in Table 18.⁸ This meant a contraction in the base of the most important local revenue producer, the property tax. Tax delinquencies rose precipitously and further restricted the tax base. The decline in property values forced a contraction in debt margins (almost all localities are limited legally in their borrowing to a fixed percentage of assessed valuation of the property within their jurisdiction), and undermined the credit standing of localities, so that many of them could not borrow even within their restricted debt margins.

Even the largest cities had serious difficulties in obtaining funds. In New York City, for example, property valuations declined from \$19.6

⁷ *State and Municipal Compendium*, Part I, June 30, 1942, p. 8.

⁸ Although measurements of assessed valuation are far from precise, the trend is unmistakable.

TABLE 18. Assessed Valuation of Property (Localities)
1929-38

(in billions of dollars)

1929	167.6
1930	169.3
1931	161.3
1932	150.3
1933	141.3
1934	136.6
1935	135.4
1936	136.2
1937	139.2
1938	139.3

Source: U. S. Bureau of the Census, *A Decade of Assessed Valuation 1929-1938*, State & Local Government Special Study No. 14 (Washington, July 1941), PP. 4-5.

billion in 1932 to \$16.6 billion in 1935. Tax collections declined from 88 per cent of levies in 1924 to 22 per cent in 1933. The total receipts of the general fund, including receipts from state taxes, shrunk from \$120 million in 1929 to \$77 million in 1933. Coupled with this unsound financial background was an increasing relief load. Moreover, the city had a vast amount of short-term paper which it found impossible to meet or fund. The administration was confronted with periodic crises whenever a new series fell due. The solution of their difficulties lay in the Bankers Agreement, which involved budget-balancing provisions, tax-delinquency policy, tax-collection procedure, and further economies. The state legislature reduced the mandatory scale of wages for the teachers so that the city could more successfully complete the deflationary policy imposed upon it.

This was the price that many cities had to pay in order to fund their short-term obligations or receive temporary credit. In Detroit relief was slashed in half, since loans could not be placed unless the city finances were improved. The experience of Chicago was similar.⁹ Thus, in many instances, credit could be obtained only upon a deflationary reduction in local expenditures.

Although many of the state governments had serious difficulties and several—Arkansas, South Carolina, and Louisiana—were forced to

⁹ William C. Beyer, "Financial Dictators Replace Political Boss," *National Municipal Review*, Vol. 22 (April 1933).

default, on the whole they were in a better financial position. Several assumed the debts of the localities and others extended them credit. Georgia, Tennessee, and Arkansas absorbed the county road debt. Twelve states gave aid to their counties for highway debt servicing. Delaware assumed the school debt. California and Illinois extended loans to their localities for relief. Massachusetts extended short-term credit to its subordinate units on security of tax titles. Another, though more indirect, way to bolster local credit was to purchase local securities. In 1936, the states held over one billion dollars' worth of such securities.

The difficulties faced by the localities and several of the states in obtaining credit forced the federal government to come to their aid. A hesitant beginning in the extension of federal credit was made through the Reconstruction Finance Corporation. The RFC was authorized in 1932 to make \$300 million available to states and their subdivisions for purposes of relief and work relief, and to make additional loans for self-liquidating projects. Later acts broadened RFC authority in making loans to public bodies, but the total amounts involved, as shown in Table 19, were relatively small.

A number of difficulties were involved in the RFC loan program. It was slow in getting started—only \$96 million were disbursed to states and localities in 1932—and it was beyond the reach of most localities. Legal obstacles blocked the cities from getting federal credit: many had reached their debt limits and were ineligible for further loans, and some were restrained by state law from issuing revenue bonds. The RFC emphasis on self-liquidating projects prevented the localities from obtaining funds to carry on their regular functions and their emergency-relief expenditures. Moreover, many localities were not prepared to present acceptable public-work plans and others found themselves entangled in legal complications. The RFC interest rates of 4.5 per cent and over were prohibitive to a large number of cities already overburdened with interest charges.

A more realistic appraisal of the plight of municipalities led to the Public Works program, inaugurated in 1933. Having as its objective the creation of employment through the construction of public works, the PWA not only made loans to states and their subdivisions for the financing of public works, but outright grants as well. Under the NIRA program, allotments to public bodies were made on the basis of an out-

TABLE 19. Reconstruction Finance Corporation Loans to States and Localities 1932-35

(in thousands of dollars)

Purpose	1932	1933	1934	1935	Total
For relief and work relief	79,967	220,018			299,985
For self liquidating projects *	15,737	47,866	67,952	59,792	191,347
To or for the benefit of drainage, levee, and irrigation districts		2,414	9,884	37,806	50,104
For repair of damage by earthquake, fire, etc *			160	1,101	1,261
State funds created for the purpose of insuring repayment of deposits of public moneys		5,888	2,500	2,377	10,765
To a public-school authority (Illinois)			22,300		22,300
Total	95,704	276,186	102,796	101,076	575,762

Source Reconstruction Finance Corporation, *Report for Fourth Quarter 1935*, Table 7, pp 68, 73, 76, 80-83, and *Report for Fourth Quarter 1938*, Table 4, p 32, and Table 11, p 104 All amounts represent disbursements

* Including a few small loans to private enterprise Of the \$305 million in loans extended by the RFC by the end of 1938 for state and local self-liquidating projects, over \$250 million went to governmental units in California and some \$22 million went to New York. The rest of the country received very little indeed

right grant of 30 per cent of the cost of labor and materials, the balance of the cost to be provided by the recipient or borrowed at 4 per cent from the PWA. In later PWA programs, the grant was raised to 45 per cent of the cost of the project. The relative proportion of loans and grants distributed by PWA for nonfederal projects, as of June 30, 1941, are shown in Table 20. The PWA grants enabled many localities,

TABLE 20 PWA Loans and Grants for Nonfederal Projects as of June 30, 1941

(in millions of dollars)

Total estimated cost of projects	\$4,203
Local funds provided	1,878
Federal allotments:	
Loans	817
Grants	1,508

Source Federal Works Agency, *Second Annual Report 1941* (Washington, 1941), p 310 The amounts represent allotments.

which otherwise would have been financially unable to do so, to participate in the public-works program.

As a federal credit institution, however, the Public Works Administration was limited in scope. Loans were extended for specific projects only and, in fact, largely for self-liquidating projects. The emphasis on self-liquidating projects resulted mainly from the attempt to circumvent the strict debt limits which had brought many municipalities to the end of their power to borrow for general purposes. In a few states, laws were already on the statute books providing for the issuance of obligations (called revenue bonds) payable solely from the revenues of self-supporting municipal enterprises, for the acquisition, construction, or improvement of which the obligations were issued. The PWA encouraged and sponsored the extension of revenue-bond financing, especially through securing the passage of revenue-bond legislation.¹⁰ The majority of municipal securities purchased under the PWA programs were payable solely from revenues of self-sustaining projects or were special revenue obligations additionally secured by recourse to taxes or other funds (see Table 21).

TABLE 21. Municipal Securities Purchased by PWA by Type as of February 7, 1939
(in millions of dollars)

Unlimited tax obligations	219	
Limited tax obligations	22	
Special tax obligations	9	
Revenue obligations (payable solely from revenues of project or system)	307	} 54%
Special revenue obligations (additionally secured by recourse to taxes or other funds)	15	
Special assessment bonds	6	
Miscellaneous obligations	18	

Source: Public Works Administration, *America Builds*, 1939, p. 276, Table 4.

Though the absolute amount of securities purchased by the RFC and the PWA was not large, the influence of such purchases was felt

¹⁰ The courts in most states accepted the "Special Fund Doctrine," which holds that an obligation payable solely from the revenues of an enterprise in connection with the acquisition or improvement of which it was issued does not constitute a debt within the meaning of constitutional or statutory limitations.

in a crucial period they not only helped to create a market for municipalities, but had an important stabilizing influence. It is abundantly clear, however, that the basic problems of municipal credit in periods of depression have not as yet been solved.

PROSPERITY RESERVES

A second source of funds for states and localities in depression is that of accumulated reserves. The availability of such funds depends on the foresight of the authorities and their resistance to pressures during the previous period of prosperity. Unless the prosperity period is of sufficient duration, the reserves cannot be expected to be of quantitative importance. The most that can be hoped for is that they cushion the first impact of the depression, and help to stop the deflationary spiral. Two safeguards are necessary. Adequate provision must be made to guard against raids on the reserves in prosperity, and against depreciation of values in depression. If the downturn is sudden and severe, the bonds accumulated in the reserves may be dumped on the market when funds are wanted by the government, with serious deflationary effects on the market and on security values. This can be avoided if reserves are kept in part in the form of special federal securities, and if national agencies are directed to purchase bonds offered by the state and local reserves.

STATE AND LOCAL TAXES

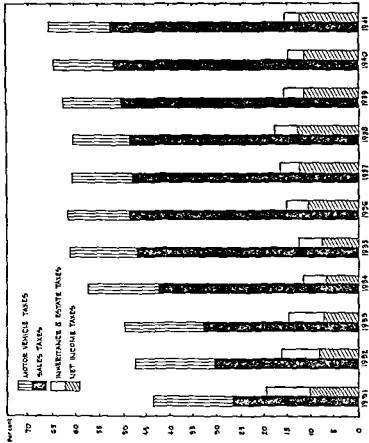
As we have already noted, the states rely chiefly on taxes weighing heavily on consumption, and such taxes are unfavorable to business recovery. Chart VI shows the relative importance in the state tax structure of sales and motor-vehicle taxes as compared with death transfer taxes and net income taxes (including personal and corporate net income taxes as well as franchise taxes based on net income).

The reliance on consumption taxes arises largely from the inadequate yield of other state taxes. Although a majority of states now have personal income taxes, these taxes, with few exceptions, yield relatively little revenue. This can be explained in part by the fact that wealthy individuals are concentrated in a few centers, and many states do not have a large income base.¹¹ Moreover, competition among the states

¹¹ In 1938, for example, the percentage of incomes of \$5,000 and over to total state income payments ranged from a minimum of 2½ per cent to a

CHART VI

Relative Importance of State Sales, Motor Vehicle, Net Income and Death Transfer Taxes



(selected taxes as percentages of total state tax collections, excluding payroll taxes, fiscal years 1931-41)

TABLE 22. Relative Importance of State Sales, Motor Vehicle, Net Income and Death Transfer Taxes (selected taxes as percentages of total state tax collections, excluding payroll taxes fiscal years 1931-41)

Year	Motor Vehicle Taxes (per cent)	Sales Taxes * (per cent)	Inheritance & Estate (per cent)	Net Income Taxes (per cent)
1931	16.47	26.99	9.39	10.07
1932	16.75	30.27	7.99	8.24
1933	16.74	32.92	7.57	7.22
1934	15.26	42.21	4.89	6.76
1935	14.33	46.81	4.86	7.74
1936	13.30	48.36	4.61	10.44
1937	12.67	47.94	3.96	12.53
1938	12.13	48.27	4.67	12.84
1939	12.69	50.07	4.42	11.32
1940	12.66	51.69	3.55	11.35
1941	12.89	52.41	3.35	12.19

Sources: Tax Institute, *Tax Yields 1940*, p. 48, and 1941, p. 49, respectively

* Includes taxes on gasoline, general sales, tobacco, admission, oleomargarine, liquor, and soft drinks

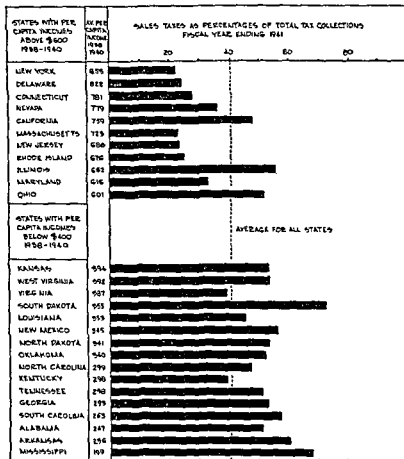
limits the steepness of income-tax rates which any one state can impose. A further limitation, especially for the agricultural states, arises from the difficulty of assessing farm incomes. Also, a number of the states do not possess the administrative and legal talent required to administer a modern progressive income tax.

The shift to consumption taxation during the thirties was due, in part, to the inducements offered by federal grants. Since the income tax and other cyclically sensitive taxes yielded little revenue, the states—in their desire to secure revenues that would enable them to obtain WPA and social-security grants—turned to the least cyclically sensitive and (the then) most productive tax base, i.e., the transactions base.

The reliance on taxes which weigh heavily on consumption makes it inevitable that the state tax structure should have a serious restrictive effect on the national economy during periods of depression. Moreover, as shown in Chart VII, the burden of consumption taxes gener-

maximum of 28 per cent. In 35 of the 48 states, taxable incomes of \$5,000 and over amounted to less than 10 per cent of total income payments. Social Security Board, Bureau of Research and Statistics, *Fiscal Capacity of the States: A Source Book*, Supplement, Bureau Memorandum No. 43 (Washington, January 1942).

CHART VII
State Sales-tax Burden Related to Economic Capacity



(sales taxes as percentages of total tax collections, including payroll taxes, fiscal year ending 1941)

TABLE 23 State Sales-Tax Burden Related to Economic Capacity

States with Per Capita Income above \$600, 1938-40	Sales Tax * Collections, 1940-41 <i>(in millions of dollars)</i>	Total Tax † Collections, 1940-41	Sales Taxes as Per Cent of Total Tax Collections, 1940-41
N.Y.	137.7	618.7	22.3
Del.	3.2	13.1	24.4
Conn.	19.7	72.3	27.2
Nev.	1.8	4.9	36.0
Calif.	175.3	367.8	47.6
Mass.	39.1	171.1	22.9
N.J.	34.4	148.2	23.2
R.I.	6.7	26.9	25.1
Ill.	156.2	280.9	55.6
Md.	20.4	62.1	32.8
Ohio	155.3	300.9	51.6
States with Per Capita Income below \$400, 1938-40			
Kan.	24.0	45.0	53.3
W. Va.	33.0	61.6	53.6
Va.	26.3	67.4	39.0
S. Dak.	12.6	17.4	72.2
La.	38.6	84.8	45.5
N. Mex.	10.4	18.5	56.2
N. Dak.	8.6	16.1	53.4
Okla.	32.7	62.9	52.0
N. C.	46.8	99.5	47.0
Ky.	23.7	60.6	39.1
Tenn.	27.9	55.2	50.4
Ga.	31.9	59.9	53.2
S. C.	23.6	41.2	57.4
Ala.	31.3	62.0	50.4
Ark.	22.2	36.9	60.1
Miss.	24.7	36.4	67.9

Source: U. S. Bureau of the Census, *State Tax Collections 1941* (Washington, February 27, 1942), pp. 16-18, Table 4.

* Includes taxes on gasoline, admissions, liquor, tobacco, general sales, soft drinks, and other sales taxes.

† Includes payroll taxes.

ally is heavier in the poorer states than in those with relatively greater economic resources. Thus, it is in the areas where purchasing power is characteristically at a very low level that taxes constitute the greatest drain on consumption.

Since localities are restricted in their ability to borrow, the level of their outlays will depend on the yields of the property tax—upon which they are almost entirely dependent—unless they have accumulated reserves or receive substantial grants from the federal government or from the states. Since a property tax constitutes an overhead cost for individuals and businesses, it deals harshly with those whose incomes contract in depression, unless adjustments in assessments are made immediately. With property taxes levied at high rates in most areas, delinquencies can be expected during a period of depression. As shown in Table 24, such was the experience of local units in the thirties.

TABLE 24. Tax-Delinquency Trend
1930-40

(Median percentages of year-end tax delinquency in cities with population over 50,000)

Year	150 Cities	20 Cities with Unstable Records
1930	10.15	11.85
1931	14.60	18.55
1932	19.95	27.20
1933	26.35	39.05
1934	23.05	34.55
1935	18.00	28.55
1936	13.90	21.15
1937	11.30	14.00
1938	10.70	13.10
1939	9.25	11.60
1940	8.70	9.40

Source: F. L. Bird, *Trend of Tax Delinquency 1930-1940 in Cities of over 50,000 Population* (Dun & Bradstreet, 1941), p. 14.

If a locality should attempt to sustain its outlays by raising tax rates to compensate for the losses due to delinquencies, the number of delinquencies would probably be increased. In a depression, also, the

high rates of the property tax tend to have a depressing effect on real-estate values and on the rate of private construction.

In addition, over-all property tax limits, imposed by a number of states, have operated to reduce the effectiveness of the real property tax in providing local revenue. The tax-limitation movement in general has been sponsored by real-estate groups as a means of obtaining relief from taxes. This type of limitation places an additional strain on municipal finances in times of stress, and essential services of the community may suffer as a result. Homestead and other exemptions which are provided in a number of states have further narrowed the base of the real-estate tax.¹²

GRANTS-IN-AID

Grants from the federal government constitute another source of income for states and localities which may enable them to maintain their expenditures during periods of depression. Since most states find their financial resources severely limited in depression, they can do relatively little to aid their subordinate units. Chief reliance must be placed upon the federal government.

Today most federal-aid acts apportion fixed sums of money among the states for specific purposes on the basis of service need (generally measured by population), and require that the federal grant be matched by state and / or local funds, usually dollar for dollar. The Social Security Act follows in general this pattern, and authorizes grants equal to expenditures from state and local funds to help finance certain public-assistance programs falling within the limits of the federal act. With a few minor exceptions, the varying fiscal capacities of the states are not taken into consideration in the distribution of federal grants.

Experience has indicated that where a grant is based on a matching or other uniform-ratio basis, the larger per capita grants generally go to the states with the greater economic and financial resources, and the states with the lesser resources as a rule receive the smaller per capita grants. For example, taking per capita federal grants to each state for old-age assistance, aid to dependent children, and aid to the blind, for the period of three years after the inception of these grants in 1936, we

¹² Other problems in connection with the property tax are discussed in Chapter XII.

find that those states with the lowest per capita incomes, except in a few instances, received relatively the smallest volume of grants. About three-fourths of the states whose per capita grants were below the average for all states also had per capita incomes below the national average.¹³

Moreover, while the wealthier states generally—or in periods of depression, those states which are least affected—can take advantage of federal grants with comparative ease, the states with the least resources—or in a depression, those hit the hardest—can do so only at the expense of unaided activities or by burdening their residents with heavier, and generally regressive, taxes. Thus, those governmental units which are most dependent on outside aid, if they are to maintain their services, receive the least assistance under the present grant-in-aid system.¹⁴

In conclusion, it seems clear that state and local finances in prosperity and depression fall far short of achieving the objectives of a rational fiscal program. It remains for later chapters to discuss what can be done to achieve these objectives.

¹³ See Daniel S. Gerig, Jr., "The Financial Participation of the Federal Government in State Welfare Programs," *Social Security Bulletin*, Vol. 3 (January 1940), Table 2.

¹⁴ It is true, nonetheless, that federal grants have been successful in stimulating the states generally to a higher level of performance in the aided functions. The grant-in aid problem is discussed more fully in Chs VII and VIII.

PART TWO

Means of Strengthening the Fiscal Base and of Raising Service Standards

Chapter Five

MODERNIZING LOCAL GOVERNMENTS

LOCAL governments need to be modernized. Without this, improved service standards, equity in tax burdens, and fiscal soundness cannot be achieved. In many instances local governments comprise ineffective and uneconomical service areas, and frequently lack sufficient resources to command competent administration. Service standards thus suffer and local self-government as well.

THE ORGANIZATION OF EFFECTIVE SELF-GOVERNING UNITS

To achieve a well-balanced local unit of government certain conditions must be satisfied. These conditions are: the local governmental unit should be large enough in terms of population and taxable capacity to permit the effective and economical performance of local services; service need and legal jurisdiction should extend over the same area; the local unit of government should cover an entire integrated community such as a metropolitan area.

In the first place it is necessary to determine the "optimum" local *service* unit. One approach would be to decide which of the existing units of government (i.e., the state, the counties, the cities and towns, or the special districts, with their present legal boundaries, and administrative setup) can best administer each of the local services. If one

unit is not qualified to perform a function efficiently and economically, then the function might be transferred to some other unit.¹ But this procedure is not always the most desirable. For example, it might be demonstrated that within a given state, effective police protection cannot be administered by the existing counties at a reasonable cost. It could be argued that the function should logically be shifted to the state. It does not follow, however, that the state is necessarily the ideal administrative unit for police protection. The best agency for administration of the function might well be a *better organized* county unit, i.e., a county unit of sufficient size to permit sufficient division of labor and specialization to make police protection economical and efficient. Thus it is necessary to determine the type and size of unit best adapted to the administration of the more important local services, without concern for any pre-existing organization or boundaries of local units.

In the case of many of the public services, two or more layers of government are involved. Complex administrative interrelations arise, partly because of our federal system, and partly because of the nature of the administrative process. There may be various degrees or types of supervision and control, both horizontal and vertical, for a single public service, and fiscal management and reporting may be involved at each point. For example, the primary responsibility for the "administration" of justice may rest with the state. The state may, however, delegate the "administration" of the courts to certain of its subdivisions. Thus, both levels of government are involved in carrying out this function. Or to take another example, the federal government makes grants-in-aid for vocational education. These grants go to the state department of education, which in turn assigns them to local educational units. The federal government keeps a check on the use of the funds and on the maintenance of certain minimum standards. The state supervises the use of these funds, together with the funds which it may add for the same purpose, and may lay down certain broad directives concerning vocational education. The local unit, in turn, uses the federal and state grants, together with its own monies, to finance the individual schools under its control, and directs and supervises the activities of such schools.

¹ New York State Commission for the Revision of the Tax Laws, *Reorganization of Local Government in New York State, Sixth Report*, Legislative Document No. 63 (Albany, 1935), p. 30.

Administrative interrelationships are determined by many factors, such as tradition, the character of the groups in power at the various levels of government, the relative degree of national, state, and local interest involved in a given public service, the types of taxes used to finance the service, the locus of the taxpayer, the desire and capacity for self-government, the relation of the service to the regional or national economy, and many others. Because of the dynamic character of most of these determining factors, administrative interrelationships can be expected to change and constantly do. But whatever intergovernmental arrangement is made in carrying out a given public service, the problem remains: What type and size of unit is best adapted to perform the *local* function?

Available statistics reveal that the per capita governmental *expenditures* of municipalities generally increase with the size of the community. Broadly speaking (there are many exceptions) the expenditures of government are generally lowest in the municipalities with populations of less than 25,000; intermediate in municipalities in the population class between 25,000 and 300,000; above the 300,000 level, per capita outlays generally continue to increase with the size of the unit. Precise data concerning per capita *services* in amount and quality are not at hand, yet one observation remains indisputable: the larger cities perform many functions and services for their citizens that are unknown in the smaller cities; and further, the larger cities are demonstrably more efficient in such matters as health, sanitation and fire protection.² Thus we must sharply distinguish between per capita *expenditures* and *cost of service rendered*.

In this connection, it is interesting to note the situation with respect to services and costs in the cities, towns, and villages of Milwaukee County. The Joint Committee on Consolidation in Milwaukee County has presented figures which show that the number of services performed by localities increases directly with population. The committee also points out that: "The city of Milwaukee's per capita cost of performing 339 activities is just about the same as the per capita cost of the seven largest suburbs to perform only an average of 140 activities. The nine smallest suburbs average 55 activities."³

² See the series of articles on administrative efficiency by Clarence Ridley and Herbert Simon in *Public Management* (1937-1938).

³ Joint Committee on Consolidation in Milwaukee County, *Metropolitan Milwaukee* (1936), p. 79.

In general, *cost* of specific services, in contrast with total per capita *expenditures*, in cities of various size is difficult to measure because of the widely varying services rendered. It is revealing, however, to examine service costs at the county level. Counties within a given state tend to render fairly comparable services to their residents, especially since many of their functions are mandatory. It is significant, then, that throughout the country, county per capita *costs* rise the smaller the population.

A study of costs in Minnesota indicated that: "Per capita costs of county operations decline rapidly as population numbers increase to the ten thousand level, and continue to decline up to a point somewhere between the thirty and thirty-five thousand level."⁴ A similar conclusion is reached by William Anderson, who suggests that in Minnesota "a county of about 35,000 people can have about as economical an administration as one still larger, but that taxpayers in small counties must expect to have to pay more per capita."⁵

A Texas study revealed that the per capita costs of "general government," as well as the per capita costs of specific county functions, tended to decrease as the population increased. "General-government" costs per capita were found to be lowest in the counties with a population of over 30,000; while total per capita costs (including all county services) were at the lowest point in the counties with a population of over 35,000.⁶ Similarly, it has been suggested that in California a county for minimum costs as well as optimum service should have a population of 50,000.⁷

The tendency for county costs to vary inversely with population size is strikingly revealed by an examination of county general-government revenues by population-size classes. In fiscal 1941, according to Census figures, tax and nontax collections for all counties were as follows:

⁴ Minnesota State Planning Board, *Report of the Committee on Administrative Units* (November 1934), mimeographed, p. 4.

⁵ "The Reorganization of Local Government in Minnesota," *Minnesota Municipalities*, Vol. 18 (February 1933), p. 102.

⁶ H. C. Bradshaw and L. P. Gabbard, "Possible Savings through Changes in Local Government," *Bulletin, Texas Agricultural Experiment Station*, No. 540 (April 1937), p. 37.

⁷ Charles Aiken, "California proposed County Consolidation," *National Municipal Review*, Vol. 23 (June 1934), p. 327.

TABLE 25. Per Capita County General-Government Revenues by Population Size Classes: 1941

Population Class	Tax Revenue	Nontax Revenue	Total Revenue
over 250,000	\$6.78	\$1.07	\$7.85
100,000-250,000	7.87	1.15	9.02
50,000-100,000	6.91	1.09	8.00
25,000-50,000	8.79	1.48	10.28
10,000-25,000	8.94	1.41	10.35
5,000-10,000	11.47	1.47	12.94
under 5,000	18.77	2.42	21.19
All counties	7.87	1.23	9.10

Source: U. S. Bureau of the Census, Division of State & Local Government, *Financing Federal, State and Local Governments 1941* (Washington, September 1942), p. 89.

The fact that the administration of a governmental unit, no matter how small, involves certain overhead costs—expenditures which are relatively fixed and unavoidable—accounts largely for the abnormally large costs of the smallest sized counties.

No matter how a state is subdivided, there are certain to be differences in property values, as well as in per capita income, as between the subdivisions. This is due to inevitable differences in soil fertility, industrial and commercial concentration in certain areas, and so on. When the subdivisions are small, however, the differences in taxable wealth as among the local units tend to be extreme. An Iowa study revealed that in that state the range of difference in fiscal capacity among existing local school districts is about 1 to 250.⁸ In contrast, the range among counties is one to three. Data from other states reveal comparable situations. The larger the area and population over which the local unit has tax jurisdiction, the greater will be the diversity of property and other revenue sources and the greater will be the likelihood of a more stable and productive revenue yield.

The size of the local unit determines also the effectiveness of its tax administration. The ability to make equitable assessments and reassessments in keeping with changing economic conditions, as well as the ability to make prompt collections and to handle the problems of tax delinquency, will depend on the efficiency of the tax administra-

⁸ The Institute for Government Research of the Brookings Institution, *Report on a Survey of Administration in Iowa* (Des Moines, 1933), p. 162.

tion. Full-time qualified assessors and finance officers can be supported only by large units.

Many units of local government are too small to furnish at a satisfactory standard the services for which they are responsible. They have neither the population, the administrative talent, nor the resources necessary to carry out the essential local services. Not only do residents of small units receive too little service, but they must pay too much for the services they receive. The result is that residents of small governmental units must usually bear a heavier tax burden than the taxpayers of the larger units for a comparable level of services.

In this connection we shall examine the requirements for the effective and economical performance of certain services which at the present time involve an important degree of substate administration. The services chosen are those which loom large in local budgets or are accepted as being of primary social importance; namely, education, public health, public welfare, and highway construction and maintenance.

Cutting across all these fields are certain underlying requirements concerning personnel and specialization. In every field of administration, officials and employees must be properly qualified and trained, and must receive compensation commensurate with their training. Properly qualified workers are not normally available for part-time jobs. Thus the volume of work should be large enough to employ continuously a competent staff. Economical administration requires division of work. A directing official must be in charge with a certain number of specialists under him. This is true whether the field of administration is highway construction and maintenance, education, public health, public welfare, or crime control. When the district is reasonably large, a satisfactory administrative unit can be set up on a flexible and efficient basis.⁹

EDUCATION

The most important function now administered by localities is, of course, education. Standards for satisfactory school units have been evolved from many careful studies.

In discussing school units it is necessary to distinguish between

⁹ Arthur C. Millspaugh, *Local Democracy and Crime Control*, Brookings Institution Studies in Administration No. 32 (Washington, 1936), pp. 80-81.

attendance units and administrative units. An *attendance unit* comprises the geographical area served by a single school. An *administrative unit* comprises all the area under a single system of local administration and may be composed of more than one attendance unit.¹⁰

In general, the task of an *administrative unit* is educational administration and the supervision of instruction, health, and attendance. H. A. Dawson, in his authoritative study, points out that in order to carry out its functions, an administrative unit should have, in addition to a school board to formulate policy and a superintendent to execute them, a program of supervision. This would require a supervisor for each 40 to 50 teaching positions, a trained librarian, a public-health nurse for every 2,000 children, and an attendance supervisor for every 6,000 children. These persons, together with the necessary clerical staff, total about 30 employees. Such an organization would accommodate approximately 10,000 pupils and 280 teaching positions. *A school system of such size could be supported by a population of around 50,000.*

Modification may, of course, be necessary and supervisors may be required to work in two or more specialized but related fields. It is estimated that the absolute minimum size of a reasonably effective local unit of school administration is one that has approximately 1,600 pupils and 45 to 50 teaching positions. Thus, only those governmental units having 8,000 or more population are sufficiently large to be considered as reasonably effective administrative units for school purposes.¹¹ However, if maximum effectiveness is to be obtained, i.e., if the performance of functions in more than one specialized field by any individual is to be avoided, a local unit of school administration must include about 10,000 pupils, or an area with a population of around 50,000. Dawson concludes:

The proper planning and organization of local school units will solve, or facilitate the solving of, a number of vexing educational problems now facing most of the States. Among these problems are the simplification of the apportionment of State school funds, the equalization of financial burdens and of educational opportunity, at least up to some acceptable minimum, the planning and construction of school buildings, and the provision of

¹⁰ Howard A. Dawson, "Presentation of Principles on Satisfactory Local School Units," *Reorganization of School Units*, U. S. Office of Education, Bulletin 1935, No. 15 (Washington, 1936), pp. 6-7.

¹¹ Based on the fact that the school enrollment is usually about one fifth of the total population.

expert leadership, administration, and supervision. In fact, so far as the great majority of rural children in this country is concerned, the provision of acceptable educational opportunities awaits the organization of satisfactory local school units.¹²

PUBLIC HEALTH

The functions and activities accepted as good health department practice include: (1) vital statistics, (2) communicable disease control, including tuberculosis and venereal diseases, (3) maternal and child hygiene, (4) sanitation, including water, food, and milk control, (5) public-health laboratory, chiefly for diagnostic and sanitation tests, (6) health education, and (7) provisions for sanatorium and hospital care. According to the authoritative study of Wilson G. Smillie, the minimum full-time personnel required to carry out the essentials of a rounded health program must include a qualified health officer, several nurses (the recognized standard being one nurse for every 5,000 persons), a sanitary inspector (ideally, one for every 15,000 persons), and clerical assistance.

Smillie points out that generally it would not be feasible for cities with a population of less than 50,000 to employ a full-time qualified medical health officer and the other required personnel. As for rural health administration: "In a county having a population of 25,000 or less, it has not been found feasible to organize standard county health unit service. . . . Even in counties with a population of 25,000 to 30,000 people, but with a large, sparsely settled area and a total annual income of less than \$10,000,000 (\$300 per capita) a standard county health unit is not a feasible organization unless a substantial subsidy is received from the state."¹³

Where local units as now organized are too small to establish a health department with a minimum standard personnel, a possible plan is for several contiguous local governmental units to pool together to form a "health district." According to Smillie, such a health district should consist of a population of about 50,000 persons and an area not to exceed 1,000 square miles, with a ready means of communication. On the whole, however, "the plan has many administrative pitfalls. . . . Each governmental unit concerned is jealous of its own preroga-

¹² Dawson, *op cit.* p. 12.

¹³ Wilson G. Smillie, *Public Health Administration in the United States* (Macmillan Co., New York, 1940), p. 374. See Chs. XXIX and XXX.

tives and autonomy. In many instances a single unit will withdraw its support on some slight pretext and thus endanger the whole project. Thus the district plan requires strong support and close supervision by the central (state) organization."¹⁴

The Princeton Local Government Survey, in its report urging the readjustment of local services and areas, points out that "the operation of an effective program of public health is not technically practical for areas under 50,000 population," and suggests that reallocation is called for which will "provide a sensible basis for full time public health protection." The possibilities are: "(1) Regional health districts comprising contiguous municipalities with combined population of 50,000 or more; (2) county health units, excluding municipalities (with adequate health units) over 50,000; (3) combined health districts comprising a municipality possessing an adequate health unit, and one or more neighboring municipalities."¹⁵

A report on Virginia suggested that "an area occupied by approximately 60,000 people affords the minimum economical unit for the administration of public health, provided the means of communication are satisfactory and the area to be covered is not excessive."¹⁶ A report on Iowa declared: "The larger the unit of rural population, not to exceed 100,000, the more economically and efficiently can the health services be rendered."¹⁷

PUBLIC WELFARE

It is widely recognized that economy and effectiveness in welfare administration require co-ordinated administration, trained personnel, and a service adjustable to economic conditions.

The Princeton Local Government Survey suggests that "for best results" in carrying on properly developed welfare services the welfare unit should cover a population group of about 50,000:

The figure of 50,000 population is based on the assumption that the unit for public welfare administration should embrace all types of care except

¹⁴ *Ibid*, p. 387.

¹⁵ Princeton Local Government Survey, *Local Government in New Jersey, Readjusting Local Services and Areas*, Pocket Report Series, Vol. 2, No. 3 (Princeton, 1937), pp. 18-19.

¹⁶ *Report of the (Virginia) Commission on County Government*, December 1931, p. 22.

¹⁷ The Institute for Government Research of the Brookings Institution, *op. cit.*, p. 263.

actual institutionalization. General dependency, classified care, supervision of persons on parole from institutions, and investigation of probable institutional cases should be integrated in the same unit. The administrative unit should be an agency for classification, remedial treatment, and custodial care outside of institutions. *It should moreover be equipped to expand rapidly to meet emergency conditions due to general unemployment.* An administrative unit, thus fully developed, would probably require a population group of at least 50,000 although the character and composition of the population itself would affect the total figure.¹⁸

The Commission Reporting on the Reorganization of Local Government in New York State suggested that: "Larger units of welfare administration appear to be essential with the county as a minimum area of administration. . . . The area of administration for public welfare should as far as practicable be coterminous with the area for administration of public health."¹⁹ In an earlier report, this commission urged the establishment of coterminous health and welfare administrative units "large enough in population to support an efficient full-time service for each function with the minimum demand for state aid." Outside of large cities, such units would be (1) a single county, or that part of a single county having a population of more than 50,000, or a county having less than 50,000 population which, because of its area, location, distribution of population and highway communication, can be most efficiently and economically administered as an independent unit; or (2) a district made up of two or more counties or parts of two or more counties whose population is less than 50,000 each.²⁰

A Virginia report suggested that in the administration of public welfare, as well as in health administration, the minimum economical unit is an area occupied by approximately 60,000 people.²¹

HIGHWAY CONSTRUCTION AND MAINTENANCE

Throughout the country, state governments are responsible for the construction and maintenance of primary roads within state-wide sys-

¹⁸ Princeton Local Government Survey, *op cit*, Note 16, p. 51.

¹⁹ New York State Commission for the Revision of the Tax Laws, *op. cit.*, p. 19.

²⁰ New York State Commission for the Revision of the Tax Laws, *Depression Taxes and Economy through Reform of Local Government*, Third Report, Legislative Document No. 56 (Albany, 1933), pp. 128-129.

²¹ *Report of the (Virginia) Commission on County Government*, December 1931.

tems Roads related to the state highway system (rural feeder roads and connecting streets) and those not related (minor rural roads and the bulk of city streets) are generally administered by a local unit.²²

The requirements for an effective and economical local road unit, it is generally recognized, include the following: (1) It should be of sufficient size (a) to support competent full time technical supervision; (b) to own and maintain the usual equipment necessary for construction and proper maintenance without increasing unit costs; and (c) to support economically a sound cost system and traffic record (2) It should have jurisdiction over a logical transportation planning area.²³

Transportation, broadly conceived, both determines and is determined by the form and location of urban communities. It is a well-known fact that peripheral city areas and suburbs tend to develop along highways. City growth and dispersion are also affected by rapid-transit facilities. At the same time, the economic and physical character of the entire urbanized area—the so-called metropolitan district—determines the transportation and terminal needs of the area. Co-ordinated transportation planning and administration are clearly called for. There is need for the integration of terminal facilities for the various forms of transportation—docks, airports, railway terminals, storage and parking facilities, and the highway approaches to each. The location and design of transcity connecting streets, express highways, and belt lines or bypasses are matters that require co-ordinated study

²² In Delaware, Virginia, North Carolina, and West Virginia, however, highway administration is centralized in the state.

²³ Summarizing a careful analysis of road administration within the state, a New York Commission reports: "State and county units, in general, supply better maintenance at less cost than the towns." New York State Commission for the Revision of the Tax Laws, Sixth Report, *op cit.*, p. 190. William Anderson, analyzing Minnesota data, reveals: "An examination of county road expenditures for 1929 indicates that these also tend to be higher per capita in the least populous counties and smaller in counties of larger population . . . In the seven counties having from 14,000 to 16,000 inhabitants they ranged from \$6.38 to \$11.86 per capita, whereas in the seven having from 23,000 to 26,000 the range was from \$4.71 to \$9.73, and in the five having from 33,000 to 36,000 the range was from \$4.10 to \$7.86. 'Normal expenditures' per capita for roads in these three groups of counties were figured at \$8.30, \$5.60 and \$5.37 respectively. The fact that per capita road expenditures seem to increase with per capita assessed valuations somewhat confuses the trend, but still it is very clear that the counties smallest in population are at a distinct disadvantage in maintaining economical road service." *Local Government and Finance in Minnesota* (University of Minnesota, Minneapolis, 1935), p. 297.

of the physical and traffic conditions of the entire urbanized (metropolitan) area, together with integrated planning and administration.

The important report of the Bureau of Public Roads on *Toll Roads and Free Roads* has clarified certain of the road problems in urban areas.²⁴ The heaviest highway traffic is made up of "a multiplicity of short movements into and out of the city" and is chiefly of local generation. In important urban areas, especially, relatively little of the traffic is of a "bypass" nature, since even longer-range traffic, in considerable part, is destined to or has originated in the city.

In the provision of adequate traffic facilities one of the major difficulties is that of obtaining right-of-way for widening or other increase in the highway facilities. Generally such right-of-way may be obtained only at heavy cost because of the closely crowded suburban residences and industrial establishments. In order to meet the planning problems adequately, the proper unit of road administration in urbanized areas is one which covers an entire metropolitan district.

Beyond the vicinity of cities, the road problem is quite different. Among other objectives of rural highway administration are (1) establishing direct connections between the major cities, involving the bypassing, for through traffic, of small communities, (2) eliminating railroad grade crossings, (3) providing satisfactory connections between rural trade centers; serving farms, rural homes, and rural commercial, social, and religious establishments, and (4) promoting desirable rural land use.²⁵ The importance and interrelationship of these factors have led to the acceptance of the state as the logical unit for rural highway planning. Expert opinion is also agreed that the construction and maintenance of all rural roads of relatively high use should be a state responsibility, and that the state should exercise a comprehensive

²⁴ U. S. Department of Agriculture, Bureau of Public Roads, *Toll Roads and Free Roads*, 76 Congress 1st Session, House Document No. 272 (Washington, 1939).

²⁵ It is obvious that the selection of rural roads, especially the secondary and feeder roads, for improvement should be consistent with the probable future use of the lands served by them. In fact, to a certain extent the selection of roads for improvement may be the means, over a long period, of fostering a desirable movement from less to more favorable lands. By widening the margin of advantage between the less and the more favorable lands, the improvement of rural roads may become a useful instrument for inducing an economically and socially beneficial resettlement of the rural population by a gradual and natural process. See U.S. Department of Agriculture, Bureau of Public Roads, *ibid.*, p. 114.

supervision over all rural roads. The improvement and maintenance of secondary, feeder and minor rural roads outside the state system should be the responsibility of a local administrative authority of sufficient size to meet efficiency standards.

It is difficult to establish the minimum area and road mileage for such a local unit of road administration, but various cost studies have made it clear that "large" road units are more effective and economical than "small" units. The Survey of Administration in Iowa made by the Institute for Government Research of the Brookings Institution pointed out that: "With the road mileage in the secondary systems ranging from 600 to 1,400 miles per county, it would appear that the volume of work in most counties is sufficient to justify both the cost of an engineer of the calibre required for secondary road improvement and the outlay required for a full complement of maintenance equipment."²⁶ It is likely, however, that where the more important secondary roads are placed within the state system, and only the minor rural roads remain within the realm of local administration, a road unit with less mileage than the Iowa minimum would suffice. The Princeton Local Government Survey has indicated that for such purposes, "The figure of 100 miles (of local roads) has been fixed by competent engineering authority as representing a sufficient work volume to support full-time engineering, technical supervision, and use of mechanical equipment."²⁷

EXISTING LOCAL GOVERNMENT STRUCTURE

An analysis of the requirements of effective local units serves to emphasize certain of the shortcomings of the present organization of local government. These defects account for much of the distortion in our service and tax structures, and they tend to nullify, in part at least, the advantages of local self-government.

William Anderson has rendered an invaluable service in presenting a comprehensive analysis of *The Units of Government in the United States*. Here is the picture of the governmental structure as it stands today:

²⁶ The Institute for Government Research of the Brookings Institution, *op. cit.*, p. 308.

²⁷ *Princeton Local Government Survey, op. cit.*, Note 7, p. 48.

TABLE 26. Units of Government in the United States

The nation	1
The states	48
Counties	3,050
Incorporated places (cities, villages, etc.)	16,262
Towns and townships	18,998
School districts	118,308
Other units	
Water control	2,911
Irrigation & conservation	712
Rural road and bridge	1,688
Urban improvement	227
Urban utility	702
Housing authorities	525
Soil conservation districts	107
Miscellaneous	1,510
Total "other units"	8,382
Total governmental units	165,049

Source. William Anderson, *The Units of Government in the United States*, Public Administration Service No. 83 (Chicago, 1942).

All of the 165,000 local units have separate governing bodies with power to levy taxes. They are not only numerous but they are piled one on top of the other, so that there are a number of tiers or levels as follows:

Units of central government:

1. The nation
2. The state

Units of local government:

3. The counties
4. Cities, villages, boroughs, incorporated towns, towns and townships
5. School districts
6. Other special districts

In some states, the number of levels of local government directly affecting the average person is relatively small. In others, the average citizen is in direct contact with three levels of local government: the county, the city or village (urban) or township (rural), and the school

district. There may also be special districts. In some large cities, notably Chicago, there are many layers of governmental units.²⁸

The number of local units varies greatly; from 96 units in Rhode Island to 15,629 units in Illinois (including 102 counties, 1,138 incorporated places, 1,436 townships, 12,129 school districts, and 824 other special districts) Kansas has 11,206, Missouri 10,992, Minnesota 10,409, Wisconsin 9,514, Nebraska 8,509, and New York 8,329 local governmental units.²⁹

Of serious consequences is the fact that most of the existing local units have less than the minimum population required for effective and economical service units. Of the 3,050 counties, 2,370 (or 78 per cent) have less than 35,000 population; 699 counties have less than 10,000 residents. Of the 16,239 incorporated places (cities, villages, etc.) classified according to population, the overwhelming majority have less than 10,000 population; only 335 incorporated places have 30,000 or more residents.³⁰

The smaller the units of local government within a state, the greater is the likelihood of inequalities, as between the units, due to fortuitous circumstances. To give one example, in Wisconsin 65 per cent of the taxes collected by the state from public utilities are returned to the towns, cities, and villages; "the accident of location of the public utility properties determines whether the locality has this money dumped into its lap, or whether revenues must be painfully extracted from the general property tax. The Lakeside plant of the Milwaukee Electric Railway and Light Company is in the town of Lake. The tax on gross revenues and general property on this plant collected by the state and returned to the town of Lake amounted to \$33.00 per capita in 1934-35. The 17 towns, cities and villages (in the Milwaukee metropolitan area) averaged \$2.65 per capita revenue from the public utility taxes."³¹ Wisconsin also shares the income tax with its towns, cities, and villages. As is to be expected, certain of the wealthy suburbs, incorporated as villages (and sometimes specifically for the purpose of lightening the tax burden of the wealthy residents), need to raise relatively little from property taxation because of the large income-tax

²⁸ *Ibid.*, p. 12.

²⁹ *Ibid.*, p. 17.

³⁰ *Ibid.*, pp. 27, 32.

³¹ Joint Committee on Consolidation in Milwaukee County, *op cit.*, p. 92.

receipts from the state.³² The windfall effects of the fortuitous location of large utility properties and of the concentration of wealthy individuals in the Milwaukee metropolitan area are graphically presented in Chart VIII. This situation in the Milwaukee metropolitan area is by no means exceptional. Throughout the country the existence of small local units makes for inequality in tax burdens, with some units reaping the gains of unjust enrichments, while the residents of other units must bear an unduly heavy burden in taxes.

Another defect inherent in the present organization of local government is unnecessary overlapping. Local units are piled one on top of the other, with resulting duplication of functions, overlapping authority, and overlapping taxation and debt.

The consequences of the overlapping are serious: (a) the costs of carrying out the local services are increased unnecessarily; (b) the fixing of direct responsibility for efficiency and economy in the performance of local functions is made extremely difficult, if not impossible; (c) the development of a sound local tax structure is hampered; and (d) serious inequities in tax burdens are inevitable. In addition, with the piling up of units, the local government pattern becomes too complex for democratic government. There are too many officials to elect and watch, and the voter tends to lose both interest and control.

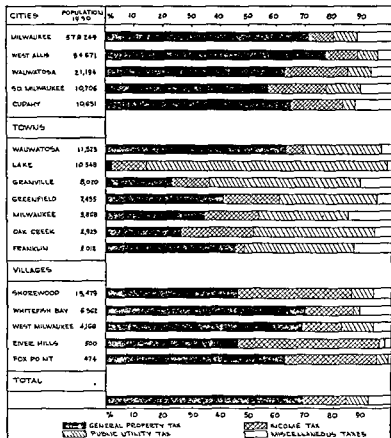
Serious difficulties stem from the fact that municipal governments and metropolitan areas do not coincide. Throughout the country, central cities are demarcated legally from the rest of the metropolitan area—the periphery being made up of a multiplicity of independent local units of government.

The pattern is similar in all parts of the country. Cities grow from small beginnings. Legal boundaries—often starting with only a few square miles—are stretched somewhat, but become fixed long before the city approaches its full growth. For example, Philadelphia is but one-tenth of a square mile larger than it was in 1854; San Francisco is the same size as in 1856; St. Louis remains within the straightened boundaries drawn for her in 1876. Population spills over the boundary into the rural areas beyond. This movement is speeded up, on the one hand, by cheap and rapid transportation facilities and the lure of

³²The normal state income tax is distributed on the basis of 10 per cent to the county of which the taxpayer is a resident; 50 per cent to his town, city, or village, and 40 per cent to the state.

CHART VIII

Relative Reliance on Various Taxes by the Local Units in the Milwaukee Metropolitan Area



Source: Joint Committee on Consolidation in Milwaukee County, *Metropolitan Milwaukee* (1936)

cheaper housing, lower taxes, and suburban living conditions outside the city, and, on the other hand, by the growth of the business center in the city, the spreading of blight and other factors which steadily push outward the sections within which families no longer can find satisfactory living conditions. As the population in various suburban areas becomes sufficiently dense and numerous, the need arises for municipal services; and new units are incorporated to meet the need. Thus, the central city comes to be ringed about by a chain of other incorporated places, of all types, sizes, and shapes. Together with their overlayers of counties, townships, school districts, sanitary districts, sewer districts, water districts, health districts, park districts, etc.—each of them a separate governmental unit—these communities present a complex and bewildering picture. They perform related or even identical governmental functions with some degree of co-operation, but with a great degree of competition for municipal revenues and for legal powers. "All this governmental duplication, confusion and localism are in sharp contrast to the obvious disregard of the network of urban boundary lines by epidemics which complicate urban health work, by criminals who are not stopped by city limits, and by the city and suburban users of highway and transportation facilities who seldom know or care about the maze of political boundaries in metropolitan districts."³³

Almost 63 million people—47.8 per cent of the total population—were living, in 1940, in the 140 metropolitan districts as defined by the United States Bureau of the Census.³⁴ Two-thirds of the metropolitan population lived in central cities; one-third in suburban municipalities and unincorporated areas.

Most of the suburban units are very small. Of the 1,697 incorporated suburban municipalities, 80.1 per cent had a population of less than 10,000. More than 62 per cent were places of less than 5,000 population.

³³ National Resources Committee, Urbanism Committee, *Our Cities, Their Role in the National Economy* (Washington, 1937), p. 67.

³⁴ U. S. Bureau of the Census, *Sixteenth Census of the United States 1940, Population*, Vol. 1 (Washington, 1942), p. 58. The Bureau of the Census defines a metropolitan district to include "all the thickly settled territory in and around a city or group of cities" of 50,000 or more population. The central cities and "all adjacent and contiguous minor civil divisions (townships, etc.) having a population of 150 or more per square mile" make up this thickly settled territory *Ibid.*, p. 11.

More than 45 per cent of the suburban units are so small that the Bureau of the Census does not classify them as urban.

The multiplicity of governments in the metropolitan areas is best indicated by the fact that, besides a very large number of overlapping authorities, there were, in 1930, 272 separate incorporated places in the New York-Northeastern New Jersey metropolitan district, 135 in the Pittsburgh district, 115 in the Chicago district, 92 in the Philadelphia district, 22 in the St. Louis district, and 56 in the Los Angeles district.³³

In addition to the difficulties involved in the existence of a large number of independent local units within metropolitan areas, the widespread movement away from central cities to suburban districts has imposed many serious problems on the cities. It is significant that the population of suburban areas grew at a rate nearly three times that of their central cities between 1930 and 1940. Within each of the large industrial areas the dominance of the major city has tended to lessen significantly since the turn of the century. At the same time, a great expansion in the number of establishments and in factory employment has occurred in suburban districts. This movement has been accelerated under the impact of war production.

The relative growth of peripheral areas as compared with central cities has been striking in recent years. This is illustrated by a comparison, for five major metropolitan centers, between the city proper

TABLE 27. Relative Growth of Central Cities and Industrial Areas
Percentage Increase 1935-39

City	Retail Sales		Volume of Manufactured Products		Wage Earners Employed	
	City proper	Industrial area *	City proper	Industrial area *	City proper	Industrial area *
New York	12.1	27.1	12.0	45.0	5.7	19.8
Philadelphia	16.4	31.7	13.6	41.0	-2.7	13.3
Detroit	22.4	50.0	1.6	3.4	-6.2	-5.3
Cleveland	18.9	42.0	25.8	55.0	-1.7	18.3
Chicago	26.8	45.3	18.6	55.6	9.5	30.6

Source: Leverett S. Lyon, "Economic Problems of American Cities," *American Economic Review*, Vol. 32 (Supplement, March 1942), p. 310.

* Excluding city.

³³ National Resources Committee, *op cit*, pp. 66-67.

and the industrial area in per cent of increase from 1935 to 1939 of several significant factors.

The artificial setting off of the central city from the rest of the metropolitan district raises a number of serious problems.

(a) It means not only the existence of a multiplicity of local units in the metropolitan area, but the continual establishment of new local units as the movement away from central cities persists. Between 1930 and 1940, 108 new municipalities were incorporated within the various metropolitan areas. During the same period only 11 corporate units were dissolved by complete annexation to the central city or another suburb, and only 9 were disincorporated. Many of the local units in the periphery are too small and have insufficient resources to furnish public services at a satisfactory standard. Thus, all the disadvantages of small units and of overlapping of authority (which have been discussed above) are being magnified with the increasing growth of peripheral areas.

(b) The existence of satellite communities and peripheral growth adds directly to central-city costs through the city's services to residents of areas outside the city. Leverett S. Lyon writes:

Millions of dwellers in parasitic dormitory cities daily make use not only of streets in the central city which have been widened and developed with special lighting, traffic signals, and police protection, to accommodate them, but also of numerous additional services such as food and building inspection. To make it easy for the residents of these dormitory suburbs to rush in and out, many cities have assumed heavy costs in building transportation routes. Boston, for example, has borne all, or nearly all, of the cost of an elaborate system of rapid transit that is used chiefly to carry the metropolitan population to and from the city, while the same population, says an Urban Land Institute study, has never paid for, or assumed, its fair share of the maintenance of corporate Boston. There are few cities, indeed, which, in the construction of "through" routes, "express" boulevards, or "outer" drives, do not furnish similar service. Nor is that all. To the dormitory cities themselves, other services, like water, sewers, fire protection, and schools, are frequently furnished below cost. Thus, the central city subsidizes its own competition.⁸⁸

(c) Individuals, industries, and merchandising establishments are encouraged to leave the central city by the fact that they can retain

⁸⁸ Leverett S. Lyon, *op. cit.*, p. 315.

many of the advantages of the city—the trading and transportation facilities, the theaters and schools, and so on—and yet escape the tax burden involved in maintaining those very city services. Certain independent suburbs become, in fact, nothing but “tax-escape colonies.” This means that those who remain in the central city must bear a larger burden per capita, and, in certain instances, the city may find itself unable to maintain service standards, or for that matter even certain of its services. In general, there are striking inequities in tax burdens for the maintenance of service used in common by the inhabitants of a metropolitan district.

(d) With authority divided among a large number of local units, over-all planning for the improvement and development of the metropolitan area is extremely difficult, if not impossible. Obviously, if a balanced industrial-commercial-residential structure, an effective transportation system, and effective public services are to be provided for the area, planning and development must be on a metropolitan-wide scale. The central city alone cannot do this because of limitation of its power, because of the difficulty of getting agreement among a large number of independent authorities with a variety of special interests, and because of the difficulty of providing for a fair division of costs.

A “MODERNIZED” PATTERN OF LOCAL GOVERNMENT

The recommendations of expert research groups, both public and private, for the reorganization of local units and services within particular areas follow—in broad outline—strikingly similar patterns. Generalizing certain of these recommendations and integrating them with the results of studies concerning the administration of essential services (such as education, public health, welfare, and roads), it is possible to set forth the broad goals of local government modernization.³⁷

³⁷ Obviously, problems of local organization vary from state to state. It is therefore clear that no one solution could be applied throughout the entire country. To take one example, the organization of metropolitan governments would have to take a different form where the metropolitan district flows over state lines than it would where the district is entirely within a single state. However, from our past experience, and from careful and comprehensive research studies, have evolved certain general concepts concerning desirable local government organization.

METROPOLITAN GOVERNMENTS

Every integrated urban community having a population of over 35,000-50,000³⁸ should be organized as one local ("metropolitan") government. Wherever possible it should be a single administrative unit for all local services and have one governing body (rather than split into several layers such as county, city, school and special districts—each with separate governing bodies). It should cover the entire urbanized area—with a rural fringe to allow for expansion,³⁹ thus containing the suburban areas as well as the central city.

Such integration of large urban communities is much to be desired. It lays the foundation for efficient, economical, and democratic local government, since it brings together self-government, an effective service area, and taxpaying capacity. "A unified local government in a city will be important enough to attract able men to its service, and simple and visible enough to be watched and controlled by the voters. . . . A balanced program of financing and public service may be worked out in such a unified government. Overhead expense can be held down to a minimum. All wastes due to overlapping and duplication can be eliminated. In fact, almost every political, administrative, and economic consideration seems to argue for a unified local government in each city."⁴⁰

An integrated metropolitan government would, moreover, be in a position to plan for the physical and economic development of the community. Transportation and terminal facilities could be co-ordinated to meet the needs of the urban community. The physical layout of the area—including the location of and balance among dwellings, business and industry, parks and recreational facilities, and public services—could be planned and developed in an integrated fashion, thus enabling the people to carry out their basic activities with the maximum of ease and well-being. In addition, the costs of government within the metropolitan area could be distributed upon an acceptable and equitable

³⁸ Such a wide range seems necessary to make allowances for difference in local conditions within various regions of the country.

³⁹ Care must be taken, of course, to prevent hedgehopping and the needless running of rural areas, when ample room for expansion exists within the existing limits of the city.

⁴⁰ William Anderson, *op cit*, pp. 41-42.

basis, and the fiscal activities of the local government could be planned more effectively to meet the requirements of economic soundness.

Basic to the concept of self-government is that those who have interests in common may be in a position to manage those joint interests by themselves. This basic tenet is contradicted if local governments fail to conform to areas of unified social and economic interests. The very existence of integrated urban regions, tied together by industries, utilities, transportation facilities, theaters, public institutions, and other pivotal points of urban life, testifies to the common interests which have drawn people together.

It has been argued that groups living outside central cities have interests which they do not share with the in-city dwellers. Assuming such interests to exist, they certainly are subordinate to the mutual interdependence of the total population of the metropolitan district, and do not justify the existence of a multiplicity of independent—and in many cases parasitic—units of local government. Their existence has no more justification than would the breaking up of central cities into small, independent villages.

There are, however, common interests on a submetropolitan level. These center about what is commonly termed the "neighborhood." More and more of the new building developments in and around cities are on a neighborhood basis, with a balance between homes, shops, schools, playgrounds, and other facilities. It is anticipated that in the replanning and rebuilding of cities, the neighborhood concept will play a central role. Civic centers—combining education, library and recreation facilities, and voting places—express the main civic and social forces of the neighborhood. Local self-government can truly be revitalized if people in a neighborhood get together to discuss common problems and interests (such as safety measures for children, avoidance of unnecessary noises, neighborhood recreation facilities, etc.), and also to study and discuss the problems of the metropolitan government of which the "neighborhood" is a part.

Certain of the plans which urge the development of urban neighborhoods have envisaged a neighborhood legislative body equipped with an administrative arm for the accomplishment of objectives which the neighborhood wants and in which the metropolitan government is not interested. The remedy suggested, however, may be worse than the cure. Nevertheless the central thought back of the plan has merit

and could probably be implemented, without danger to orderly government, in the following manner. Neighborhood units might provide themselves with a representative body which would have the right to submit proposals for change in any one or more of the municipal services (zoning and traffic regulations, etc.) to the central metropolitan legislature. In the event that special services were asked for, they could be paid for by the initiating neighborhood through a special tax in that neighborhood area, as a part of the regular city tax bill. Such a proposal—which might need to be further refined to be workable—would give the neighborhood a voice and would nevertheless prevent the growth in urban areas of a new Frankenstein monster such as the village has turned out to be in many New York suburban areas.⁴¹

ADMINISTRATIVE COUNTIES

Areas outside the metropolitan districts should likewise be organized into unified administrative units with a self-governing focus. Since such areas do not form clearly defined, integrated communities in the same sense that cities do, the delimitation of such units should be based upon considerations of density and homogeneity of population, topography, land use, economic interdependence, trade areas, transportation and communication facilities, and distance, but the controlling factors should be the administrative efficiency and economy of the more important and more expensive functions—chiefly, education, road maintenance, public health and welfare, and tax administration. This latter consideration would call for a minimum population of 30,000–50,000.⁴² Such units, for the sake of convenience, are here referred to as administrative counties.⁴³

⁴¹ Suggested by Mr. Philip H. Cornick in a letter to the authors.

⁴² In large, sparsely populated areas, such as in Nevada, a lower minimum population is called for.

⁴³ In line with the principles upon which the preceding suggestions have been based, it seems logical that both the metropolitan units and the administrative counties should be at the same time units of local self-government and agencies for the performance of state purposes. This arrangement is characteristic of the New England towns, and offers many advantages in economy, avoidance of duplication, and simplification of state-local relations.

The establishment of modernized local units should clear the way for effective local government, including good administrative organization, qualified personnel, desirable administrative practices and procedures (involving sound systems of budgeting, accounting, reporting, and purchasing), long-range planning, and legal powers commensurate with local responsibilities. The

Since administrative counties would usually contain towns as well as rural areas, and since such populated districts have certain specialized interests and require a number of urban services, these urbanized districts, when large enough, might be organized as *administrative divisions* of the county to perform certain special urban functions—such as water supply, sewerage, street maintenance and street lighting, traffic control, housing, utilities, parks and recreation facilities. For all other purposes, the urban districts (i.e., the small cities and villages) should be an integral part of the administrative county. For rural sections and for small urban areas, the county should perform all local services.

Rather than establish *ad hoc* agencies for the performance of special services, it would be desirable for local units to employ the technique of separate "assessment districts." Those who receive any special service would pay for the extra benefits received through the device of higher tax rates within the designated "assessment district." In the administrative counties, those living in the "urban districts" would pay taxes at a higher rate than those living in the rural sections because of the more expensive services rendered them by the county. Similarly, farmers provided with public irrigation facilities would pay for the service, within their special "assessment district," through the imposition of an additional rate.

As in the case of the metropolitan units, the administrative counties could bring together an effective service area, taxpaying capacity, and self-government. In fact, "aside from any traditional attachment of the people to existing county and township boundaries, and the strength of vested political interests in maintaining them, the rural areas would seem to offer the best possible place for carving out ideal administrative areas."⁴⁴

UNORGANIZED TERRITORIES

Sparsely populated areas (submarginal farm areas, wooded and cut-over territories, exhausted mineral areas, etc.) which are unable to support social services should be administered by the state government as "unorganized territories." Local government, which in such

ultimate goal must be to evolve modern local governments capable of coping with the dynamic and complex problems of modern society.

⁴⁴ William Anderson, *op cit*, p. 43.

areas can be nothing more than an empty shell, should be removed entirely and the administration of minimum essential services, such as policing, highway maintenance, and transportation of children to schools, should be a direct state responsibility. Although such a shift would be desirable from the standpoint of guaranteeing for residents of sparsely settled areas the minimum essential services without exorbitant costs of administration, its major importance lies in placing a direct responsibility upon the state for the planned rehabilitation or abandonment of the "unorganized territories."

PRACTICAL PROBLEMS INVOLVED IN MODERNIZING LOCAL GOVERNMENTS

The forces which stand in the way of the rationalization of local units of government are formidable. They include (a) local loyalties, which induce people to resist the dissolution of local governmental units regarded as their own; (b) tradition, or the tendency to think of arrangements made in the past as having an inherent rightness and permanence; (c) desire of local office holders to hold onto their jobs; (d) resistance of individuals and businesses to reorganization which might increase their tax bill; (e) resistance of businesses that are getting special favors from existing local governments; (f) resistance of local units that stand to lose some of their taxable resources; (g) urban-rural antagonisms especially where it is felt that a change might involve additional burdens or a loss of power. The list might be expanded, but the obstacles already noted will suffice to indicate the many-sided difficulties involved in local reorganization.

The forces resisting change have been highly successful thus far. To date there has been little advance in the rationalization of local units of government. For example, in spite of the persistent recommendations for county consolidation by various "reorganization" commissions, and in spite of the fact that permissive laws have been enacted in a number of states, only two actual consolidations have taken place (two counties in Tennessee were merged in 1919 and three Georgia counties were united in 1932). These are the only tangible results of the county-consolidation movement. Similarly, extremely few annexations have been accomplished in recent years.

Some thoughtful students of local government, considering the lack

of progress in reorganization of local units, have urged the complete centralization of the important services in the state governments. And, as a matter of fact, the reallocation of functions from local to state governments has gained momentum within the last generation. It is entirely possible that certain of the services now administered chiefly by localities should logically be state functions. However, even if a number of services were reallocated, the desirability of rationalizing local units would still remain.

The modernization of local government should be undertaken as an organic whole. Perhaps the most effective procedure is for each state to establish an expert commission to draw up alternative plans for the total reorganization of local government within the state, to hold public hearings for the expression of all points of view, to provide a constitutional convention for the adoption of a plan for reorganization, and to submit the plan to the voters of the state. In this way, a balanced plan could be evolved, the whole problem would receive the attention and interest it deserves, and democracy would be given a fair chance to function.

This alone, however, would not be sufficient. The gains of reorganization should be made concrete and understandable to all citizens. Thus, for example, the presentation of plans for the formation of metropolitan governments should be accompanied by programs for city rebuilding which would capture the imagination of all the metropolitan residents—programs of rebuilding which would provide for rapid transit, off-street parking facilities, beautiful parks and recreation centers, and balanced and attractive neighborhoods throughout the entire metropolitan area. The advantages of unified planning and development and the co-ordinated provision of services must be given concrete form.

Similarly, the plans for the dissolution of local governments in sparsely populated areas should be accompanied by definite programs of land utilization, soil conservation, reforestation, and rehabilitation, so that the advantages of direct state responsibility for "unorganized territories" could be seen and understood.

The success of democratic government depends in very large part on its capacity to make adaptation to change. Progress has, however, been blocked by two factors. First, changes have been attempted piecemeal, with the result that small but active and vocal minorities, with

clear-cut selfish interests to uphold, have been able to concentrate their energies and outshout the diffused voices of reform. Second, the positive advantages of local government modernization have not been brought home in a concrete manner to the mass of citizens.

"Adaptation" does not mean, when the direction is manifest, that we must proceed piecemeal and by trial and error, as if we were feeling our way through uncharted territory. Rather, it implies the need for positive action once the goal has been clarified. Thus, in the modernization of local government, boldness of action (as signified by a comprehensive reorganization through a constitutional convention) is essential. It is, however, important that machinery be provided for continued adaptation to changed conditions through democratic means, so that the elasticity and vitality of democratic government may be preserved.

Chapter Six

RESOURCE DEVELOPMENT, URBAN RE-DEVELOPMENT, AND FISCAL CAPACITY

THE improvement of state and local finance depends partly upon strengthening the underlying economic base, partly upon developing a rational and systematic program of federal aid, and partly upon reorganizing state and local tax structures. In this chapter we turn to a consideration of the first of these—the physical and economic basis of fiscal capacity. This involves, of course, not merely the productivity of local areas, but also of the nation as a whole.

ECONOMIC EXPANSION

Only if we succeed in creating a vigorous and expanding economy can we hope to achieve substantial and permanent fiscal improvement. This fact seems elemental enough, yet there is an unfortunate tendency to overlook it. Too often financial problems are treated in a vacuum. Energies are expended upon patching up and plugging holes where they might better be directed toward an attack on the underlying causes. Few are the city financial reports which, together with a statement of tax yields, discuss the undermining effects on the tax base of an ever expanding area of slum and blight. Nor are we accustomed to budget messages which urge land-use programs as measures for sustaining governmental revenues, or which discuss public expenditures in terms of their effects on the income and productivity of the community. Yet just these things constitute a significant part of the fiscal problem. Improvements in fiscal structures of a substantial and permanent nature can be achieved only if a broad and productive economic base can be developed within each area and in the nation as a whole, and if full employment and high income levels can be maintained. There is need for a shift in emphasis from narrow financial considerations to the underlying economic factors.

It is evident that if the fiscal health of state and local governments

is to be assured, positive programs of postwar economic expansion and full employment looking toward the full, balanced, and efficient use of resources throughout the country are imperative. Such programs would involve many elements—agricultural adjustment and planned improvement in land resources, industrial expansion, replanning and rebuilding of cities, resource conservation and development, and improvement in the health and productivity of our human resources.

THE RELATION OF FISCAL TO ECONOMIC CAPACITY

All taxes ultimately must be paid out of income. Clearly, then, the ability of a nation, state, or local government to raise revenue—or what is called its *fiscal capacity*—depends essentially upon the level of real income within the area over which it has jurisdiction—or upon *economic capacity*. In the final analysis it is economic productivity which determines the degree to which social and individual needs and demands within any given governmental jurisdiction can be fulfilled. This holds for the needs fulfilled by government services as well as those supplied by private activities.

In a large country, such as the United States, with a great nationwide market, and with subordinate political divisions, the state or municipal area within which income is received is not always closely related to the geographic area in which the income was produced. Thus the fiscal capacity of a local government may fall considerably short of its economic productivity and in other cases may exceed it. Only in the case of the federal government is there an accurate correspondence between fiscal capacity and economic productivity.

Aid from a central government may be necessary to enable a subordinate government to finance its services on a scale commensurate with its true contribution to the economy as a whole or on a scale that meets irreducible national minimum standards. Moreover, in some cases, a community may impose a tax paid out of income produced or received outside the jurisdiction in which the tax is levied. This is the case where a state taxes a corporation on the basis of business done outside of the state as well as within the state, or where a property tax is paid by a nonresident owner. Nevertheless, it remains true that the ability of a government to tap outside incomes is limited. In general, the level of economic activity in a given area is so important in deter-

mining the ability of a local governmental unit to provide adequate public services that it is of the utmost importance to improve its own economic resources.

Economic capacity rests upon such long-run determinants as the degree of industrialization, diversification of industry and agriculture, the number and skill of the labor force, the richness, variety and development of the natural resources. A sound fiscal structure requires the development within each area of a broad and productive economic base.

THE ECONOMIC BASE AND GOVERNMENT FINANCE

It is important to stress the fact that anything which undermines the economic base of an area reduces the fiscal capacity of the states and localities within the area. The misuse of land and water, the wasteful depletion of forest resources, or the ruthless exploitation of valuable minerals and metals within certain regions of the country have produced *serious and sometimes well-nigh insoluble fiscal difficulties* for the governmental units located within these regions.

The situation of forest lands that formerly yielded great wealth and gave employment to many, but now are stripped of the best stands, is exemplified in the Great Lakes cutover regions of northern Michigan, Wisconsin, and Minnesota. Originally this land possessed its native timber, was all on the tax roll, contributing to the support of schools, roads, and other public services. It could have been preserved as rich taxpaying property if logged on a sustained yield basis. But the lumberman was not interested in growing trees; only in harvesting them. After the timber was cut, the income-producing capacity of the land, and therefore its taxpaying capacity, was destroyed or drastically diminished. Some of the cutover land was converted to agriculture, even though it returned only a meager subsistence. Now isolated farmsteads prevail, agricultural returns are small, and opportunities for profitable and supplementary employment are scarce.

Cutover lands, once held in anticipation of settlement, have become delinquent as the prospect for sale and settlement has become more and more remote. Speculative values have vanished. As owners of holdings have found it unprofitable to meet carrying charges, and the

land has been allowed to become delinquent, a smaller and smaller taxpaying base is left to support local government.

The experience of Forest County, Wisconsin, serves to illustrate what has happened to local governments in cutover areas. In 10 years, between 1927 and 1936, Forest County experienced a 53 per cent decline in its tax base. As would be expected, the greatest decline in value occurred in timber property, and this was responsible for over half of the total decrease in the tax base.

TABLE 28. Decrease in Tax Base of Forest County, Wisconsin, between 1927 and 1936, by Classes of Property

Class of Property	Assessed Valuation		Decrease from 1927 to 1936	
	1927	1936	Percentage Decrease	Percentage of All Classes
<i>(in thousands of dollars)</i>				
Agriculture	709	500	29.5	4.0
Swamp, cutover, or waste ..	2,060	594	71.2	28.1
Timber	3,669	912	75.1	52.8
Residential, mercantile, and manufacturing	1,887	1,689	10.5	3.8
Total real estate	8,325	3,695	55.6	88.7
Personal property	1,518	926	39.0	11.3
Total	9,843	4,622	53.0	100.0

Source: V. Webster Johnson, *et. al.*, *A Land Program for Forest County, Wisconsin* U. S. Department of Agriculture, Technical Bulletin No. 687 (Washington, 1939), p. 21, Table 6.

The tax base of every town in the county diminished, with one town suffering a decline in taxable values, during the decade, of approximately 83 per cent. The tax burden on paying properties—measured by the tax rate on true value—increased in the county more than 22 per cent during the 10-year period. Tax delinquency has increased. Thus the chain of events, starting with the ruthless exploitation of the natural resources, has produced an increasingly strained governmental financial situation.¹

¹ V. Webster Johnson, *et. al.*, *A Land Program for Forest County, Wisconsin*,

A comparable account can be given of many other areas throughout the country, where millions of acres of once productive land have been largely ruined for further practical use by soil erosion, and where the wasteful exploitation of mineral resources has undermined the economic foundation of large regions, leaving governmental units with extremely embarrassing fiscal problems.

Similarly disastrous effects on governmental finance result from a decline in the industrial base. Consider the case of New Bedford, Massachusetts. The economic life of New Bedford grew up around the cotton textile industry. And just as the economic life of the city found itself dependent upon one industry, so, too, did the pattern of taxation evolve in intimate connection with the fortunes of that industry. During the twenties, tax collections from the cotton textile mills amounted to about one-fourth of the entire yield from real estate and more than three-fourths of the entire yield from personalty (i.e., from assessments against the machinery used by the mills in the production of their goods).

The severe secular decline in the New Bedford cotton textile industry, combined with the general cyclical depression of the thirties, dealt the city finances a staggering blow. High delinquency, heavy abatements, and sustained losses in mill establishments brought property-tax collections from the cotton mills to new lows in each succeeding year.² Collections on the year's real-estate levy on these mills in 1938 was more than 60 per cent lower than the collections on the 1926 real-estate levy. Collections from the personalty levy on the mills declined 85 per cent between 1926 and 1935, and after the latter year the tax on mill personalty was abolished. The result was the decline in property-tax collections disclosed in Table 29.

The tax rate jumped from \$27.80 in 1926 to \$48.00 in 1939. Relief and other welfare expenditures more than doubled from 1926 to 1933 and had doubled again by 1938 (from \$383,219 in 1926 to \$1,826,856 in 1938). At the same time there were marked reductions in expenditures for police and fire protection, highways, and schools (a 43 per cent decrease in school expenditures between 1926 and 1938).³

U. S. Department of Agriculture, Technical Bulletin No. 687 (Washington, 1939), pp. 24-25.

² Seymour L. Wolfbein, "The Public Finances of a One Industry City," *Bulletin of the National Tax Association*, Vol. 26 (May 1941), pp. 233-242.

³ *Ibid.*, p. 237.

TABLE 29. Property Tax Collections in New Bedford, Mass.

Year	Collections (in thousands of dollars)
1926	5,298
1927	5,417
1928	4,944
1929	5,164
1930	4,676
1931	4,501
1932	4,233
1933	4,196
1934	3,881
1935	3,988
1936	3,535
1937	3,359
1938	3,259

Source Seymour L. Wolfbein, "The Public Finances of a One-Industry City," *op cit*, p. 234.

The experience of New Bedford has been duplicated, in varying degree, in many other cities and towns compelled to face continued losses in revenue because of the collapse of major industries. In industrial areas, as in rural communities, the fiscal fortunes of governmental units follow closely the developments within the underlying economy.

Just as a decline in the economic base of an area undermines the taxpaying capacity of the community, so the strengthening and broadening of the economic base serves to create taxable wealth and income. For example, land which has been developed through irrigation projects has an assessed valuation in most of the western states of 10 to 15 times that of adjoining dry land. "In eastern Wyoming, federal project land is assessed at an average of more than \$30 while unirrigated farm land surrounding it has an assessed valuation of \$2.35 an acre. In South Dakota, the valuation of irrigated land for purposes of taxation is \$30 per acre and the best dry farm land in the vicinity of a federal project is assessed at \$4.50 an acre. The average is much less. In irrigated areas to the westward, assessed values, where specialty crops are produced, run as high as \$200 or \$300 per acre." ⁴ Similar results

⁴ Statement of Commissioner John C. Page, Bureau of Reclamation, U. S. Department of Interior, *Hearings before the Select Committee to Investigate the Interstate Migration of Destitute Citizens*, Pursuant to H. Res. 63 and H. Res. 491, Part IV, Lincoln Hearing, September 17, 1940, p. 1568.

have been achieved in other areas of the country where natural resources have undergone a planned development and where the economic base has been strengthened.

RESOURCE DEVELOPMENT

Co-ordinated, long range developmental programs should be undertaken through the co-operative effort of the federal, state, and local governments within every region of the country, so that each may develop as broad a base of economic activity as its natural resources can economically sustain.⁵ The planned and intensive development of native resources and markets, facilitating industrial expansion and agricultural diversification, is vital for the poorer areas of the country; for all areas resource development is an important factor in economic progress. It cannot be emphasized too strongly that without economic prosperity there can be no sound solution of state and local fiscal problems.

Even in the regions where standards of living are lowest and where economic and social conditions present the most serious problems, there are great potentialities for expansion and a higher real income. In many of these areas we find, coupled with low individual incomes and forced migrations, rich and plentiful natural resources. This is the case, for example, in the southeastern and south central sections of the country. Quite generally, in these areas, the development and utilization of available raw materials and resources—farm, mineral, forest, water and energy resources—promise increased prosperity and improved living standards. Adequate resource development requires public investment, frequently on a large scale. And public developmental projects in turn open up opportunities, not otherwise available, for private investment.

The potentialities of co-ordinated resource development have already been demonstrated in a striking fashion by the Tennessee Valley Authority, as well as by the developments undertaken in the Columbia and Colorado River basins, in the Central Valley of California, and elsewhere.

The TVA has stimulated economic opportunity, fostered expansion,

⁵ For a suggested developmental program, see Alvin H. Hansen and Harvey S. Perloff, *Regional Resource Development*, National Planning Association, Planning Pamphlet No. 16, October 1942.

and helped to raise living standards throughout the region. This has been done through the provision of facilities such as new power installations and the improved river channel; through programs of soil and forest conservation and fertilizer development; through research designed to extend the uses of the region's resources; and through community planning, and health-promotion activities within the region. Writing of TVA's agricultural and industrial research, one of the most noteworthy aspects of the Authority's expansionist program, *Business Week* of May 25, 1940, in an article entitled "TVA Aids Private Business," describes "a history of sober scientific accomplishment in the field of industrial and agricultural research" which "fosters new industries and opens new markets for old ones." In summary, *Business Week* states: "Farmers in the TVA program are found to be buying more from the hardware store, the lumber yard, and the department store than they did before they agreed to follow a new farming practice, and markedly more than their neighbors who are following the earlier methods. . . . What TVA has done to further navigation, electric power, flood control and soil conservation is aiding not only the region, but private business."

Industrial growth in the Tennessee Valley since 1933 (the Authority dates from May 18, 1933) has been at a greater rate than that of the Southeast or the United States as a whole. Relative growths, according to Census figures, have been as follows:

TABLE 30. Industrial Expansion in the Tennessee Valley
1933-39

	Percentage Increase in Manufacturing Plants	Industrial Workers
Tennessee Valley	53.4	41.7
Southeastern States	41.1	33.9
United States	30.0	30.2

In the Pacific Northwest, in the Central Valley of California and in the Colorado River basin, developmental projects completed or on the way—to provide an adequate and pure water supply, irrigation facilities, adequate and cheap power, improved waterways—have fostered economic expansion and have given the people a new hope for the future.

The federal government should advance capital for the construction of all projects in which a substantial national interest is involved. Included are projects that, while local in scope, are involved in a region-wide or nation-wide program. Federal funds may be extended to regional and state operating agencies by (1) direct congressional appropriations, (2) guarantee of the general securities or revenue bonds of regional-development corporations, or (3) lending of federal funds.

Experience to date has shown that co-ordinated resource development, underwritten by the federal government along regional lines, can go a long way toward eliminating fiscal incapacity by creating and developing business opportunities, increasing employment, productivity, and income levels.

URBAN REDEVELOPMENT

Of importance equal to resource development in strengthening the fiscal position of local units of government is the program of redevelopment of our towns and cities.

Slum and blighted areas have an effect on our cities and towns like a rotten apple in the center of a full barrel, or like cancer on the human body. Such deteriorated or deteriorating areas undermine the urban structure by spreading their poison in ever-widening circles, by sapping the strength of the healthy sections, and by making the whole process of carrying on the life of the city more difficult and more expensive.

Slum and blighted areas have the following characteristics in common. Properties are run-down due to accelerated obsolescence, outmoded plan, and neglect of maintenance. Rents are low, though generally too high for value received; nonconforming uses are widespread, and values are steadily deteriorating. Overcrowding prevails in occupied buildings. There is lack of open space and privacy. Structures are dilapidated and obsolete. There are nuisances and dangers to public health and safety resulting from smoke, dirt, and congestion and from substandard safety and sanitary conditions. These conditions promote growing dissatisfaction with urban life.

THE ECONOMIC LIABILITY OF BLIGHT AND FUNCTIONAL DISINTEGRATION

Beyond the serious consequences of slum and blight for the health and well-being of many members of our urban communities, the deterioration of large areas involves many difficulties and problems for local governments.

Blighted areas are economic liabilities to a community. In the run-down districts the per capita cost of necessary public services—such as fire and police protection, sewerage, water supply, public utilities, transportation and street servicing—and the cost of welfare and social services tend to be substantially higher than in the rest of the city. At the same time that government operating costs in such areas increase, fiscal capacity declines. Assessed values—although they tend to remain higher than true values because of the slow process of adjustment and the reluctance of cities to reduce the tax base—must inevitably slide continually downward as the process of deterioration accelerates. And because of lessened earning power, landlords are unable to meet current taxes, and tax delinquency accumulates.

The losses incurred in the blighted areas themselves are, however, only a small part of the total economic liability. Blight is infectious and the decaying areas drag values down in the surrounding contiguous sections, undermining their ability in turn to contribute adequately to meet municipal costs. Those who can afford to do so move out of the city in the search for more congenial environment. This decentralization contributes both to the disintegration of the older districts and the increasing cost of providing government services. Much of the movement is to suburban sections, outside of the taxing jurisdiction of the city. In consequence, the tax base of the central metropolitan area contracts. This means that tax rates must be pushed higher; but this accentuates the flight from the city still more as taxpayers seek to escape the heavy tax burden. Meanwhile the scattering of the city has increased the load on municipal resources. Thus, the entire community generally suffers from inefficient planning and unequal utilization of the municipal plant.

The existence and spread of blight indicate not only the decay of physical structures, but functional disintegration as well. The urban organism lacks (a) a proper balance between dwellings, business, in-

dustry, public services and facilities; (b) a transportation and terminal system permitting efficient movement throughout the entire urban district; and (c) land uses which insure a congenial environment for living.

When social, economic, or technical changes (as, for example, the development of the automobile, or an industrial shift in the region) throw the functional pattern out of balance, and proper readjustments are not made, certain outward signs of maladjustment inevitably appear. These take the familiar forms of spreading blight and festering slum, traffic congestion, and wasted facilities. But the underlying maladjustments which are not immediately visible to the eye are of even more serious consequences for the life of the community.

Utilities and transportation facilities must supply an ever-widening area at the same time that the facilities in the decaying sections must be maintained. The per capita operating costs must inevitably increase. The supplying of municipal services, as well as the movement of goods, becomes more expensive. This is reflected in the cost of living in the community. Existing investments are constantly threatened. Less tangible, but equally important, is the fact that as a result of the functional maladjustments, living in the city becomes generally less attractive

THE FINANCIAL LIABILITY

Spreading blight and functional disintegration affect local finances so directly that it is important to appreciate the full magnitude of the problem.

A city must, of course, be viewed as a whole, and too much stress should not be laid upon its separate divisions. Nevertheless, it is interesting to note that few residential areas pay their own way. Urban governments generally depend upon industrial and particularly mercantile properties to produce excess revenues sufficient to cover losses in other sections. It must, of course, not be forgotten that business areas are service areas for the entire community and are themselves the product of the activities of the people in the residential areas. The true "losses" in the residential areas are the difference between revenues as they now are and what they might be if the city were re-developed on sound lines. Nevertheless, taking the facts as they now

are, an "income and cost" survey (for 1934) in the city of Boston,⁶ to take one example, broken down by census tracts, revealed that the "business area" (amounting to 2 per cent of the total area of the city) paid \$20.2 million of the total revenue of \$65.1 million, or 31 per cent. Figuring income and cost on a net basis for eight principal groups, the business area accounted for 71.8 per cent of the "net income," as shown in Table 31.

TABLE 31. Income and Cost for 127 Census Tracts in the City of Boston
Subdivided into 8 Groups according to Dominant Use

Group	(in millions of dollars)				(percentages of total)			
	Gross Income	Cost	Net Income	Net Cost	Gross Income	Cost	Net Income	Net Cost
Business	20.2	8.8	11.4		31.0	13.5	71.8	
Industry	5.4	6.0		.6	8.3	9.2		3.6
High rent residen- tial	3.9	1.7	2.2		6.0	2.6	13.9	
Misc. res.	7.5	5.3	2.3		11.6	8.2	14.3	
Suburban res.	8.2	11.0		2.8	12.6	16.9		17.9
3-decker res.	7.7	14.5		6.8	11.8	22.3		43.4
Low-rent res.	2.4	5.7		3.3	3.6	8.8		21.2
Not classified (incl. tax exempt)	9.8	12.0		2.2	15.1	18.5		13.9
Total	65.1	65.0	15.9	15.7	100.0	100.0	100.0	100.0

Source: City Planning Board, *Report on the Income and Cost Survey of the City of Boston*, op. cit., p. 6.

Although the income-cost relationship between the various classes of land uses varies from city to city and over the business cycle, it is an established fact that business properties generally must be depended upon to provide the bulk of "net income" (as used in the Boston study), i.e., tax revenues in excess of governmental operating costs, to cover the operating losses incurred in other sections of the city. It is obviously essential for a city to protect the taxpaying ability of the business areas and to prevent decay in the areas of high tax value.

For this reason, among others, decentralization, deterioration of central-city areas, and functional unbalance seriously undermine the tax base of urban communities. The tax base is whittled away from several

⁶ City Planning Board, *Report on the Income and Cost Survey of the City of Boston*, E.R.A. Project No. X2235-F2-U46 (Boston, 1935).

directions. Blighted central-city areas as a rule contain heavy business, utility, and railroad investments. Abandonment of these investments not only would result in a substantial loss to those holders, but it would disrupt existing services and facilities which are usually strategically located. Business enterprises located in those areas have, likewise, built trade arrangements over a period of years, loss of which must inevitably cause economic dislocations. Traffic congestion, inadequate parking space and other effects of improper layout and functional unbalance result in losses to in-town merchants, with an accompanying decline in property values.

When the "flight from the city" reaches large proportions, suburbs generally grow to a size which can support profitable business establishments. Business enterprises, under such circumstances, are induced either to leave the central business district altogether or to reduce the size of the in town establishment and to set up branch stores in the suburbs. The city tax base shrivels as a result of the movement of business beyond the city tax jurisdiction.

A vicious cycle is generated. With the abandonment or neglect of properties within the decaying sections of the city resulting in a loss of revenue, the local government is reluctant to lower valuations for tax purposes. It is often forced, indeed, to raise tax rates in order to maintain its services. In addition, land charges remain high in the blighted areas. As a consequence, renovation and rebuilding are discouraged, and the restoration of taxpaying capacity is prevented.

Blighted areas are costly to local government. Studies made in various cities show that the operating loss in blighted areas is substantial. A report presenting *An Analysis of a Slum Area in Cleveland* indicates that the costs of maintaining such an area are quite out of proportion to the income derived from the taxes on real estate.

The governmental outlays in this slum area were more than six times as large as the tax-rate income. When the Community Fund and other unofficial agency expenses in the section are added, the cost of maintaining the section reaches a total of \$1,972,437 or some 875 per cent of the real-estate taxes paid.⁷ It is estimated that an operating loss of \$78.58 per capita, or \$333 per family, is involved in maintaining the area.

The high cost of providing municipal services in slum and blighted

⁷ R. B. Naxon, *op cit*

TABLE 32. Statement of Income and Direct Expenses of Maintaining a Slum Area in Cleveland in 1932

	(dollars)			
	Cleveland City	School Board	Cuyahoga County	Total
Expenses:				
Fire department	406,159			406,159
Police department	255,597			255,597
Ash and garbage collection, street cleaning and lighting, and sewer maintenance	48,646			48,646
Health department	44,888			44,888
Other city expenses	63,439			63,439
Board of education		361,927		361,927
Tuberculosis cases			67,704	67,704
County child welfare cases			45,187	45,187
Other county expenses			63,431	63,431
Total expenses	818,729	361,927	176,322	1,356,978
Tax rate income	90,364	90,745	43,926	225,035
Operating loss	728,365	271,182	132,396	1,131,943

Source R. B. Navin, *An Analysis of a Slum Area in Cleveland*, Report of a Study Made for the Cleveland Metropolitan Housing Authority in 1934 (reprinted in unabridged form by the Regional Association of Cleveland, Publication No. 3, November 1939), p. 6

areas is obviously due in large part to the poverty of the residents. This is indicated by the high incidence of welfare and relief services. Clearly, it is difficult to estimate the excess loss due to blight alone. Yet even if the costs to the community of the crime and disease bred in slums were left out of consideration,⁸ the costs incident to physical deterioration and misuse alone are startling. Thus, the cost of fire protection in the slum section is shown to be out of all proportion to that in other parts of the Cleveland metropolitan area.

A Boston survey covering six blighted areas and reflecting 1933 operations showed that the municipal operating loss amounted to \$79 per resident of these areas.⁹ It is interesting—though not statistically sig-

⁸ Actually these social costs are high. In the Cleveland slum area the cost of police protection was \$11.50 per capita compared with \$4.37 per capita for the city of Cleveland. Public-health work involved an expenditure of \$2.02 per capita, for the city as a whole, it was \$64 per capita *Ibid.*

⁹ City Planning Board, *Report of the Income and Cost Survey of the City of Boston*, E.R.A. Project No. 2235-F2-104, 2235-F2-104A, X2235-F2-V46. See

TABLE 33. Cost of Fire Protection in Various Parts of Cuyahoga County in 1932

Area	Cost Per Capita	Cost Per Capita Per Sq Mile	Cost Per \$1,000 Appraised Value of Land & Buildings
The slum section	\$18.27	\$35.13	\$48.81
Cleveland	3.12	.44	2.59
Lakewood	2.17	.40	1.49
Cleveland Heights	2.03	.25	.88
East Cleveland	2.06	.69	1.43
Shaker Heights	2.48	.38	.63

Source: Navin, *op cit*, p. 9.

nificant—to compare this figure with that of the Cleveland report, which showed an operating loss of \$78.78 per capita for 1932 in the slum area studied. A second survey covering the entire city of Boston by census tracts, conducted in 1934, indicated that the aggregate loss in those tracts which were classified as “low rent residential” averaged \$48 per resident. There was a considerable variation in losses, the highest being \$81 per capita in one particular census tract. These calculations take account of all municipal revenues collected in these areas and all municipal costs allocated to the same areas.¹⁰

These surveys, as well as other studies which have been made, disclose a fact—now generally recognized—that cities as a whole sustain a considerable loss in the operation of slum and blighted areas. From every point of view it is clear that the replanning and rebuilding of cities in order to establish a sound and balanced physical structure are basic to the development of sound local finances. If the local tax base is to be safeguarded and strengthened, the ravages of depreciation must be overcome, a functional balance must be achieved, and attractions must be substituted which will counteract conditions that produce slum and blight and the artificial forces tending toward decentralization.

Basil C. Rodes, “Fiscal Aspects of Urban Blight,” *Taxes*, Vol. 20 (November 1942), p. 656

¹⁰ B. C. Rodes, *ibid.*

REPLANNING AND REBUILDING THE CITIES¹¹

The development of sound urban structures involves certain basic principles.

(1) *Integrated Metropolitan Planning.*—Comprehensive master planning (conceived as a dynamic system of procedures rather than merely a group of maps or charts) for the entire metropolitan district is essential in order to give direction to the redevelopment of the urban community. Such over-all planning should include, as part of the planning process, thorough social and economic research involving an analysis of the proper and desirable role of the particular urban community in the region in which it is located and in the nation as a whole, including an analysis of the industrial and population shifts affecting the community. If the economic structure of the community is not already well balanced with respect to the location and extent of the various types of industry and commerce, the possibilities should be explored of obtaining a better equilibrium. The master planning should aim at evolving a physical layout and a land-use pattern which would provide for an optimum balance between dwellings, business, industry, public services and facilities, and which would permit congenial living conditions. It must provide that in the interior of the urban community there be elbow room—plenty of it—both for the purposes of present living and working and for the necessary space to adapt the physical layout to the changes required or desired in the future.

Internal transportation should be so planned as to permit fast and pleasant movement. The aim should be not only to take account of existing arrangements, but also—and far more important—to provide guidance for future transportation development. Railroads, waterways, airlines, express highways, bridges, tunnels, the location or re-location of terminals of all kinds—all these should be studied and

¹¹ This section is based upon the discussion by Guy Greer and Alvin H. Hansen, *Urban Redevelopment and Housing*, National Planning Pamphlet No. 10, 1941; also the Report of the Conference of Urbanism (Harvard University, March 5-6, 1942), *The Problem of the Cities and Towns*, edited by Guy Greer.

See also the excellent study issued by the Federal Housing Administration, *Handbook on Urban Redevelopment for Cities in the United States* (Washington, 1941).

planned, both to meet the needs of the urban community as a whole and to co-ordinate them with the transportation facilities throughout the region and nation.

A guiding concept which is gaining acceptance, and which should be incorporated in the master planning, is the "neighborhood-in-the city" with protective belts of free land—an area freed from the disruptive forces of through-traffic, with a system of circulation designed for its internal needs, supplied with its own retail shops, play spaces, schools, public-health centers, employment security offices for job registration and consultation about benefits, public-health centers, places of assemblage for worship and civic discussion, art galleries, music halls, and recreation centers.

To carry out this type of master planning it is essential that there be a competent planning agency with adequate authority and financial support. Such a planning agency must be an integral part of the local government structure.

(2) *Land Control and Acquisition.*—If sound urban structures are to be developed and preserved, the local governments must possess adequate legal powers to control the use of the land in the urbanized area and the surrounding rural fringe. Cities cannot be reconstructed in conformity with the principles outlined above until there is a recognition "by the public and finally by the courts of the importance for our economic well being and general welfare of the right of the community to acquire and dispose of land freely, so that the powers of the state may help private as well as public groups in large-scale city rebuilding."¹²

A local authority should be empowered to control land throughout the metropolitan area, and to assemble land on a large scale in order to effectuate the master plan. Specifically the local authority should be given the power (a) to work within a broadened definition of "public purpose" including those purposes essential for the realization of the master plan; (b) to acquire, by condemnation when necessary, land anywhere within the urbanized area and around the outskirts; to hold, use or lease such land, and in any case to make certain that it shall be used only in accordance with the master plan; (c) to enact

¹² Charles S. Ascher, *Better Cities*, National Resources Planning Board Report on "Building America" (Washington, April 1942), p. 10.

and enforce ordinances requiring the owners of real property within the metropolitan area to use it or to permit its use only in accordance with the master plan.

Large-scale assemblage of land will require also the removal of financial obstacles. To remove the latter involves a problem of peculiar difficulty and one which is already the subject of much controversy. We propose federal financial aid to enable the cities and towns to purchase, or take under condemnation proceedings, whatever land in the whole metropolitan area is needed for urban redevelopment, including slum and blighted land.

Federal financial aid is proposed because, under existing conditions, most of the towns and cities would be unable to raise the money required. More specifically, a procedure somewhat as follows is envisaged. For every town or city in the country—or for every group of contiguous municipalities—a long-range master plan would be completed for the entire metropolitan area. And of course it would provide for its own subsequent revision to meet unforeseeable needs. It would be formally submitted to the appropriate federal agency in connection with an application for financial aid in the acquisition of all the real property within a clearly defined slum or blighted area. For each such area and the immediate surroundings, the planning would have to be not only complete and in accordance with the master plan, but it should also be accompanied by the data necessary to justify all assumptions as to future changes. Definitely indicated would be the proposed use of land within the area, whether for local governmental purposes or for leasing to private enterprise; and such use would be determined without regard to acquisition cost of the land. In other words, the acquisition would be the means of clearing away the obstacles to redevelopment: in arriving at a decision as to its subsequent use, the land should be deemed to be worth its appropriate use value in a soundly planned community.

Upon approval by the appropriate federal agency of the proposals to acquire property, the federal agency would be prepared to advance funds, if need be, up to the entire cost of acquisition. Repayment of the sums so advanced should be made as far as possible. In view of the fiscal position of most municipalities, however, there are strong reasons for requiring them only to pay over such sums as may be obtained from leasing the land after deduction of local taxes.

It is necessary and inevitable for our cities to turn to the federal government for the use of its credit in undertaking the restoration of blighted areas and the task of rebuilding urban communities. The problem involves the welfare of over 50 per cent of our population. The long run risks of adaptation of our centers of population and industry to changed conditions cannot be assumed wholly by individuals, but must be assumed in part by the nation. In the end the community as a whole will prosper and profit thereby, and indeed it is not unreasonable to expect that the federal government would eventually recover most, or even all, of its advances.

Although federal aid is essential, city planning must be a local responsibility. Every possible safeguard should be included in the underlying legislation (and in the accompanying discussion of the intent of the laws) against interference with the local community in planning any sort of town it wants, so long as a few indispensable and obvious standards imposed by the federal agency are adhered to.

It cannot be denied that the land in slum and blighted areas is frequently valued on a speculative and fictitious basis, higher than could be justified for the new use of the land in accordance with a sound master plan. This is partly due to the overzoning of land for business use, partly due to a reluctance on the part of city authorities to reduce the taxation values, partly due to the fact that there is in fact little sale of land and hence no real market value, partly due to the oversweating and excessive population density in slum and blighted areas which often enables owners to obtain high returns from slum properties even when such slum properties fall below the sanitary and health standards imposed by the community, and partly due to the hangover of values which were based upon rates of population growth that no longer exist.

It may be urged, however, that this situation by no means presents a hopeless picture with respect to the feasibility of acquiring slum and blighted land for urban redevelopment at reasonable prices. The federal agency, empowered to make advances for land purchase, should require proof that the cost of the property (whether acquired through purchase, condemnation, or otherwise) is reasonable and has not been increased (a) by reason of the prospective public works and utilities shown upon the master-, district-, or project-area plans or (b) by reason of the prospective assembly of the land in the project area in which the

property is located or (c) by the capitalization of earnings arising from failure to comply with the structural and sanitary standards specified in the state or local legislation regulating such buildings.

A comprehensive master plan in the nature of the case constitutes an analysis of land use in the area intended for redevelopment or development. A comprehensive master plan would give us for the first time a true basis for a sound estimate of the use value of the land. It is difficult to believe that the old, thoroughly unsound, fictitious and speculative basis for valuations could stand up against a factual analysis of the true use value of land. It is believed that a thorough presentation of the true use value of the land based on a comprehensive master plan would go far to convince the court that the fictitious values held out for by present owners are in no sense justified.

An urban redevelopment program such as here under consideration would for the first time give the city authorities a genuine interest in arriving at a reasonable valuation of the land in slum and blighted areas. Hitherto, city authorities have favored excessive valuation for tax purposes. An urban redevelopment program would, on the contrary, induce the city authorities to support and press for reasonable prices in land acquisition.

It has frequently been suggested that in view of the high values currently placed upon slum and blighted land, the proper solution would be to undertake all the new development in the suburban and outlying districts. A policy of developing outer or suburban areas without at the same time having a program for redevelopment of the slum and blighted areas would, however, be a self-defeating policy, for it would increase the blight and therefore increase the ultimate cost to the community. It should, however, be remembered that a comprehensive urban plan, involving appropriate standards of maximum population density, in many cases will result in some decentralization of the existing population so that there is inherently nothing contradictory between the redevelopment of slum and blighted areas and considerable suburban development. The extent to which suburban development is appropriate depends fundamentally upon the facts as ascertained in the comprehensive master plan.

Blighted areas are for the most part admirably located for residential use; usually they are needed for nothing else. Under the redevelopment

program the population density must be reduced if future redeterioration into blight is to be avoided; and this will be impossible until their excessive valuations are drastically lowered.

If we assume that the land in the blighted and slum areas is bought up by the local governments—with such financial aid from the federal government as may be necessary—there can be no doubt that one of the greatest single obstacles to the eventual realization of a sound master plan would be removed. Such land could then be put to its best possible use in the interest of the whole community, without regard to the acquisition cost of any particular parcel. Some of it would be required, no doubt, for the development of the transportation and terminal system. Some would be needed for parks and playgrounds. The bulk of it would probably be for housing—for everything from high-priced apartments to very low-rent dwellings. And for such uses it could be offered (*a*) for lease, on terms favorable enough to attract private developers; or (*b*) to local public-housing authorities. In any case the ground rents would be based, not on acquisition costs but on the value estimated to be realized from the new use.

(3) *Building and Redevelopment.*—Once the preparation of the master plan and land acquisition are sufficiently advanced, the job of building and rehabilitation can be undertaken. The task of redevelopment can be expected to involve many techniques and procedures. It will embrace demolition, remodeling, and new construction. It will include not only residential real estate, but all other types of property—such as stores, industrial property, schools, and churches—and may involve the rearrangement of streets, utilities, and services. Meanwhile, public work activities of all kinds would be fitted into the larger program. Steady progress would be made, over the years, toward realization of the growing and developing master plan.

The desired community pattern can be achieved only through the co-operative effort of both public and private enterprise. Adequate controls must be devised so that both public works and private construction harmonize with the city master plan. In this connection, it should be possible for the city to retain ownership of land and lease it to private enterprise for redevelopment. This would facilitate flexible readjustments and control of financial arrangements in the future; if the land is resold we may find ourselves within another generation

frozen into the same inflexibilities that now hold us in their grip.¹³ If, however, sale is resorted to, every effort should be made to safeguard the control of land use in accordance with the project-area plan.

The scale of rebuilding must be large to meet the objective of providing a satisfactory physical basis for urban life. Rebuilding should be undertaken, "not by the square block, but by the square mile." We cannot hope to develop protected neighborhoods and to achieve a functional balance within the city unless the building is on a scale commensurate with the task involved.

There are many reasons why our cities and towns should be re-planned and rebuilt. From the standpoint of local finance alone, however, this much is clear. Unless slum and blight are eradicated and functional disintegration prevented, the tax base will continually be whittled away. Sound fiscal structures within our urban communities cannot be achieved or preserved until a sound layout of the city through comprehensive master planning has been achieved.

THE THOMAS BILL FOR URBAN REDEVELOPMENT ¹⁴

On April 2, 1943, Senator Thomas of Utah introduced a bill involving a program of federal aid to municipalities for urban redevelopment. The provisions in the bill go straight to the roots of the conditions confronting towns and cities, growing out of the increasing spread of slum and blighted areas and the financial limitations of towns and cities to cope with these problems.

The bill stresses the need for a comprehensive master plan in each urban community, prepared by the municipalities themselves. The bill provides for advances by the federal government to the towns and cities to enable them to make master plans.

The bill provides that the federal government shall make advances to the towns and cities to enable them to purchase and assemble the land. It is stressed that the purchase and assembly together with the making of the master plan must, however, be undertaken by the towns and cities themselves. The bill provides that the towns and cities

¹³ *Ibid.*, p. 11.

¹⁴ S. 953, 76th Congress, 1st Session. Alfred Bettman, Cincinnati attorney and member of the Cincinnati City Planning Commission, played an important role in the drafting of this bill.

shall repay the federal government out of funds obtained from the redevelopment process itself and not out of general municipal revenues.

The bill is based on the assumption that urban redevelopment will enhance the revenue-producing capacity of the blighted districts, will increase employment, reinvigorate the building-construction industry, raise the national income, and promote national prosperity and well-being. It is believed that as the redevelopment progresses, more and more the direct returns from the redevelopment process will justify the federal advances, but emphasis is especially laid on the indirect benefits accruing to the community as a whole through the revitalization of our towns and cities and the general increase in income and employment.

Chapter Seven

INTERGOVERNMENTAL CO-OPERATION

THE functions and responsibilities of the three layers of government in the United States—federal, state, and local—are undergoing a profound change. The transformation of the American society from a primitive agricultural and handicraft economy to the great industrial giant which it is today has created wholly new governmental responsibilities that affect the different levels of government. The process of industrialization—the ever-expanding volume of trade, the increasing multiplicity of transportation and communication, and finally, the concentration of a large part of the population in great cities—has created new problems for towns and metropolitan areas, for the states, and for the federal government. The evolution of industry has created a vast wage-earning class dependent upon employment for a livelihood. A hundred years ago the bulk of the population was living on farms and in rural communities. Mass unemployment and mass destitution were unknown. In this era of local self-sufficiency, the family, local poor relief, and private charity provided care for the sick, the aged, and other dependents.

Industrialization and urbanization destroyed the self-sufficiency of the family and threw new responsibilities upon communities and governments. The problems of recurring depressions and mass unemployment, problems of public health and sanitation springing from the congested conditions of urban living, destitution due to sickness and old age, could no longer be met by relying upon individual responsibility. At first the local communities sought to cope with the situation. But the devastating magnitude of mass unemployment in the great depression of the 1930's demonstrated conclusively that the local communities were no longer capable of carrying the burden alone. State governments, and finally the federal government, were compelled to assume responsibilities formerly assumed to belong to local governments alone.

The federal government came to the assistance of state and local governments in meeting these problems partly by providing work-

relief programs, partly by making grants and loans for public works, partly through agricultural relief and assistance, partly through public-assistance programs, and finally through the beginnings of a broadly inclusive social-security program.

These developments proceeded largely on the basis of improvisation to meet urgently pressing current problems. There remains to be formulated a systematic reorganization of the functions of government at the local, state, and federal level, and the development of a well-functioning co-ordination of intergovernmental relations in order to meet effectively the new problems now confronting us.

One hundred years ago, De Tocqueville wrote that he was "struck by the good sense and the practical judgment of the Americans . . . in the ingenious devices by which they elude the numberless difficulties resulting from their federal constitution."¹ Developments during the past century, including the concentration of economic power, the expansion of the sphere of governmental action, and the persistence of economic instability and unemployment have increased the problem arising from our federal system. Devices for achieving co-operation and co-ordination are urgently needed.

FEDERAL GRANTS-IN-AID, NEEDED REFORMS

Among such devices the "grant-in-aid" is one of the most important. It is noteworthy that in Great Britain, where the national government has complete control over the scope and character of all public functions, the actual administration of, and financial responsibility for, many of the public services are divided between the central and the local governments. In few, if any, countries do grants-in-aid play as important a role as in Great Britain. Thus, in unitary as in federal systems of government, it has been found that the governmental unit which is best adapted to the administration of a public service is not necessarily the unit which can most effectively raise the revenues to finance the service. Clearly, it is illogical to say that a necessary social service should not be provided because the subordinate units—which, from the standpoint of effectiveness and popular control, should administer it—cannot themselves raise revenues adequate to finance the

¹ A. De Tocqueville, *American Institutions and Their Influence* (Allyn and Bacon Co., New York, 1855), p. 165.

service. Nor is it logical to insist that a central government, which can raise the necessary revenues, should necessarily administer the service merely because it has the fiscal capacity to finance it.

It is not by accident that the grant-in-aid, as a governmental mechanism, has steadily grown in importance. In our complex modern society, the old theoretical ideal that each unit of government must raise the revenues necessary for the maintenance of all the functions which it administers is simply not workable. Against the advantages to be gained from attaching financial responsibility to administration must be balanced the advantages arising from the application of the principle that governmental functions should be assigned to those units which can most effectively perform them, while taxes should be levied by governmental units capable of assessing and collecting them effectively. A practical application of this concept means that subordinate units may find themselves in a position of having to administer more functions than they can finance.² The grant is an effective instrument for bridging the gap between fiscal capacity and capacity for administration.

In a federal system the grant-in-aid is a particularly useful mechanism. It lends a sorely needed element of flexibility to our otherwise rigid constitutional system. It is a useful device by which the federal, state, and local governments may join together in the financing of services of national as well as state and local interest. It enables the federal government to carry out a national policy without duplicating and competing with similar services rendered locally. Of no small importance is the fact that federal supervision, in connection with specific grants, has been an important element in improving state and local standards of administration.³

Two charges are often levied against the use of federal grants: (*a*) that they complicate governmental operations and intergovernmental relations; and (*b*) that they encroach upon the sovereign rights of the states. The same people who accept as a matter of course the complexity of corporate organization and interunit financial operations often find

² Tax Policy League, *Tax Relations among Governmental Units*, Symposium, 1938, Part I.

³ See Joseph P. Harris, "The Future of Federal Grants-in-Aid," *The Annals of the American Academy of Political and Social Science*, Vol. 207 (January 1940), pp. 17-18. This outstanding article has been relied upon greatly in this section.

it difficult to accept the necessity for maintaining a system of governmental interlevel transfers in order to provide the multiplicity of social services essential to a modern community. We should lose sight of our popularly conceived objectives and social needs if we attempted to make governmental operations conform to neatly drawn organization charts without any crisscrossing lines. Serious attention should certainly be given to the problem of simplifying fiscal relationships. But simplicity should not be achieved at the expense of an adequate provision of necessary social services nor at the expense of an equitable distribution of the tax burdens. The complicating element introduced into public accounts by intergovernmental transfers is heavily counterbalanced by the substantial advantages to be gained from the effective use of the grant-in-aid mechanism.

Opposition to federal aid is sometimes raised on the ground that it is an insidious means whereby the national government may encroach upon the sovereign rights of the states. A careful analysis of the question must reveal, however, that far from undermining the position of the nonfederal units, national aid is an important instrument for the preservation of state and local governments. This is true because it provides them with the means to carry on the services popularly demanded of them. Were it not for the grant-in aid mechanism, a choice would have to be made of one of several evils. (1) to leave important services without adequate support, thereby permitting the prestige of the states to suffer accordingly; or (2) to force the states and localities to extend their revenue systems to include taxes ill adapted for local tax jurisdictions, thereby introducing inequities and economically unsound elements into the total tax structure; or (3) to require the federal government to take over the administration of functions which could more effectively be administered by local officials. Thus, federal aid permits us to avoid what would otherwise be a serious dilemma. Examined in this light, federal aid to subordinate units can be made a valuable device for preserving local self-government while at the same time raising service standards and effectively utilizing the most desirable tax sources.

Federal aid has in fact greatly increased in recent years. Because it will undoubtedly continue as a major element in our system of governmental financing, it is desirable to examine carefully some of the more important features of the federal-grant program. As long as federal aid

amounted to only a few million dollars annually the problem attracted little attention. Now it has become essential to develop an integrated and balanced program, and to devote particular care to such matters as apportionment, measurement of the need of aided services, the financial abilities of the states, and the many problems of federal and state administration of the grants made. Hitherto, national policies with respect to the grant-in-aid programs have been dictated largely by those who were interested in securing appropriations, and little attention has been given to a consistent and well-administered program. There are now commanding reasons why the whole federal grant-in-aid program should be reconsidered and policies developed which will safeguard both national and state-local interests.⁴

At the present time we do not have what can be called a national grant-in-aid *system*. What we have is a series of un-co-ordinated individual grants. Consider the transfers in the fiscal year 1941.⁵ Total federal aid amounted to \$851 million. Of this sum, \$11 million were payments to the territories. Local governments received \$95.9 million, of which \$81.0 million were temporary PWA grants, \$4.8 million were housing grants, the remainder were payments to the District of Columbia and shared taxes. The states received \$744.2 million, for the major programs shown in Table 34.

Can these sums be said to represent the relative national interest in the various services administered at the state and local levels? Do they reflect a balancing of the need for the various services in relation to the state and local funds available for financing? Clearly, the answer in either case must be in the negative. Can it be maintained that there is any rationale in making payments in aid of grade-crossing improvements that are three times as large as those for public-health work and eight times as large as those for maternal and child health? Can it be maintained that general education is less deserving of federal aid than are the special types of education which are aided, or that there is a reasonable distribution of funds when general relief is completely neglected at the same time that aid for old-age assistance amounts to over a quarter of a billion dollars?

The federal grant-in-aid program cannot achieve an effective bal-

⁴ *Ibid.*, p. 17.

⁵ U S Bureau of the Census, *Federal and State Aid, 1941*, Special Study No. 19 (Washington, April 1942), p. 14.

TABLE 34 Federal Grants to States
Fiscal 1941*(in thousands of dollars)*

For Highways:

Aid for primary highways	113,392	
Aid for secondary highways	17,081	
Aid for grade crossings	29,186	
Emergency funds	8,652	
Total		168,311

For Public Assistance:

Aid to the aged	258,821	
Aid to dependent children	62,498	
Aid to the blind	7,026	
Child welfare	1,461	
State homes for veterans	1,365	
Total		331,171

For Education:

Vocational education and rehabilitation	21,945	
Defense training	61,015	
Colleges for agricultural and mechanic arts	4,854	
State Marine schools	160	
Total		87,974

For Agriculture:

Agricultural experiment stations	6,658	
Agricultural extension work	18,143	
Total		24,801

For Public Health:

Crippled children	5,071	
Maternal and child health	3,739	
Public-health work	10,284	
Veneral-disease control	5,483	
Total		24,577

For Employment Security:

Unemployment-compensation administration	62,513	
Public employment office	3,159	
Total		65,672

Other Grants and Shared Revenues

Total grants	41,660	
		744,166

Source U. S. Bureau of the Census, *Federal and State Aid 1941. op cit*, pp. 16-18.

ance nor can it be properly integrated with other aspects of national policy unless every element of the program is periodically reassessed and geared to changing relative need for the various public services. An example of a shift in relative need is furnished by the changing nature of the public-roads problem. Earlier in the century the major road problem was the construction of main rural highways, and the national interest was expressed in the form of large grants to the states for the construction of such highways. In recent decades it has become increasingly evident that provision for the safe and efficient conduct of large traffic streams into, across, and around cities deserves the highest priority for road funds; yet the federal highway grants have not been adjusted accordingly.

Unless the over-all picture is kept in mind, federal aid is likely to result in undue emphasis on some services at the expense of others. The effect of singling out a few governmental functions or parts of functions for federal aid is to place them in a preferred position in securing state and local appropriations. In fact, the success of a matching grant for a specific service is generally measured by the degree to which it stimulates the recipient units to expand their outlays on the aided service. Because a few nationally supported services (such as highways, old-age assistance, and vocational education) have been placed in a highly favored position, other governmental functions equally important and meritorious (such as general education and relief) have suffered in many areas of the country because of the diversion of available state and local funds into the aided activities. Within the poorer sections of the country, especially, the extension of federal aid for a limited number of functions tends to bias state and local budgets in the direction of the aided services; and from the standpoint of the relative need for the various social services, to distort the budgets.

A striking example of the distortion of state and local expenditures induced by federal aid is furnished by the welfare field. General relief, which is completely dependent on state and local funds, has been neglected in many instances and has undoubtedly suffered because of the drain on state and local resources caused by disproportionate old-age-assistance payments. New York State, which has attempted to maintain a reasonable balance between general relief and old-age assistance, paid out, in 1939, four times as much for general relief as the

total payments from all sources for old-age assistance, and New Jersey expended nearly three times as much for general relief as for old-age assistance.⁶ In comparison, the distortion in the welfare budgets of some of the poorer states is striking. Texas spent during 1941, with federal aid, \$14.1 million for old age assistance, but only \$1.0 million for general relief. Oklahoma spent \$8.2 million for old-age assistance while only \$5 million was spent for general relief. Mississippi spent \$1.4 million for old-age assistance, but only \$32,000 for general relief.⁷

Evidence of the distortion of state and local expenditures induced by federal aid is afforded also by a comparison within certain states of the outlays on highways, which are heavily aided, with expenditures on such services as general education, libraries, hospitals, and recreation. In general, the poorer states so extend themselves to take advantage of federal aid for certain services that they have quite inadequate resources left for other equally important services. It is undoubtedly true that all other governmental services suffer when a disproportionate part of limited state and local funds is spent on federally aided activities.

A number of suggestions for a wider use of the grant mechanism are set forth in subsequent chapters. It is proposed, in the first instance, that the concept of a national minimum be incorporated into the federal-aid system. Certain functions—education, public health, and public welfare—are of such strong national interest that the federal government should underwrite a minimum program, and insure that the minimum standards are everywhere provided without an undue strain upon state and local resources.

The extension of the federal-aid program to the above mentioned services would be the most effective solution to the problem of avoiding serious distortions in state and local budgets. The grant system would then cover the most expensive state and local functions and thus avoid favoring a few.⁸ Federal aid should be extended under broad general function grants, so that the funds may be used for all aspects of

⁶ Joseph P. Harris, *op cit*, p. 19.

⁷ Social Security Board, Processed Release of the Bureau of Public Assistance, March 25, 1942.

⁸ This is the solution that England has followed. An examination of the list of central grants to the municipalities in England indicates that practically all municipal services of any size receive central aid. See Mabel Newcomer, *Central and Local Finance in Germany and England* (New York, 1937).

the major aided services. In this way the splintering effect of existing federal aid would be avoided. This means that federal aid would be provided for welfare activities generally instead of for particular forms of public assistance; for education generally instead of for a few specialized aspects; for highway administration including the provision of facilities for traffic into, across, and around cities; and for comprehensive programs of public health including hospitals, medical care, rehabilitation, maternal and child health, etc. The major basis of federal aid should be shifted from the unbalanced stimulation of a few favored services to the support of several broad categories of services in which there is a strong national interest.

The extension of federal aid, especially for education and general relief, is the most effective device available for achieving a better balance between local government responsibilities and local financial resources, thus relieving local tax pressures. The great bulk of school costs are now borne by local communities. Moreover, a very large number of localities carry the largest share of general relief costs—the residual item in the welfare field—a responsibility for which they are ill adapted. Other methods for achieving a better balance between local responsibilities and local resources present many serious disadvantages. The adjustment of expenditures to available resources would mean (and at present does mean) inadequate provision of essential social services in many communities throughout the country. On the other hand, a substantial expansion of local revenues is out of the question, or offers extremely limited possibilities, for the poorer areas of the country. In most other communities, essentially because of limited tax jurisdiction, an expansion in revenues must involve the use of taxes that are regressive or repressive in nature (such as sales taxes) or that are ill adapted to local use. In contrast, federal aid permits retention of the benefits arising from the use of a large central unit in the administration and collection of most taxes, while preserving the benefits resulting from local administration of functions which entail local responsibility and require a knowledge of local conditions.⁹

If federal aid is to bring about fairly uniform standards in service fields in which there is a strong national interest, use will have to be

⁹ Henry J. Bittermann, *State and Federal Grants-in-Aid* (Mentzer, Bush & Co., New York, 1938), Ch. II.

made of differential or equalization aids. This follows from the great differences among the states and localities in the need for the various services, and in fiscal capacities.

Most of the states have introduced some "equalizing" factor in the allotment of state aid for education to localities. At the federal level a start has been made in this direction. Equalization has played a role in the allotment of forestry aid, of the unemployment-relief grants from 1933 to 1935, and of a part of the federal aid for public health. The methods used are significant. The United States Forest Service, in conjunction with the states, estimates the cost of providing adequate protection within each state, and this estimate is made the basis for the distribution of part of the federal aid. The remainder is allotted in proportion to the total expenditures for this purpose by the states. The Surgeon General is authorized to determine the method of allocation of federal aid for public-health services, in consultation with state health officers, the act providing that three factors shall be taken into account: population, special health problems, and the relative financial needs of the states.

If federal aids were apportioned so that a national minimum standard was achieved through allocation of grants on the basis of the need for the services and the relative financial abilities of the states and their subordinate units to provide these minimum services, several important and highly desirable secondary effects would be achieved.

1. The pressure on the limited financial resources of the poorer states would be sufficiently relieved so as to permit less reliance on regressive sales taxes and repressive business taxes; such relief of fiscal burdens in the postwar period could have a significant expansionist effect.

2. The use of equalization grants would promote a desirable regional redistribution of income. If the federal tax system retains its current progressive features (by continued heavy reliance on income taxation) the effect of placing most of the federal-grant system on an equalization basis would be to tax incomes concentrated in wealthier areas but derived from nation-wide operations. Thus, the federal-aid program could make an important contribution to the economic expansion of the deficient areas. One of the obstacles to the full development of natural resources (including industrial expansion and agricultural diversification) in the poorer regions of the country has been the low

purchasing power in these areas. To the extent that equalized federal aid increases consumer purchasing power within the deficient regions it will enhance the possibility of economic expansion. By raising the economic capacity of such areas, and thereby raising their fiscal capacities, equalized federal aid can itself help to remove over time the need for equalization, or at least to reduce that need.

3. Federal equalization aid would undoubtedly also promote a redistribution of income as between income classes within the national economy. This would be true not only of equalized welfare grants, but also of the provision of minimum programs of education and public health. The degree of redistribution of income would depend, of course, on the progressiveness of the federal tax system. But assuming such progressivity, the underwriting of a national minimum, in terms of education, public health, and public welfare, would provide a more equal distribution of income. This would contribute materially to the maintenance of consumer purchasing power and to the achievement of a high-consumption economy in the postwar period.

4. One of the important economic effects of a federal program of equalization aid would be the maintenance of public services and expenditures when depression threatens. During the depression of the thirties the decline in state and local service outlays contributed to the deflationary spiral within the economy. Education expenditures declined more than 22 per cent and public-health outlays some 20 per cent between 1930 and 1934. It is of the utmost importance not only that the essential social services should not be permitted to suffer as they did in the last depression, but also that the government contribution to the national income should not be permitted to contract at the time when it is most needed. An integrated federal-aid program on an equalization basis would not only help to maintain needed social services, but would also provide useful public expenditures as a counterbalance to depressional tendencies.

In spite of the fact that federal aid has expanded greatly in recent years, its full usefulness as a governmental mechanism has not yet been realized. A comprehensive federal-grant system has yet to grow up.

Experience with central aid both here and abroad indicates that federal grants, either singly or collectively, may promote a variety of national purposes, among which are the following:

1. To stimulate state and local governments to higher standards of service (involving, among other things, an increase in essential expenditures; improvements in administration; and reorganization of governmental units—such as local government consolidation).

2. To insure that given services are provided at a satisfactory standard in each area of the country irrespective of the relative resources within the various areas—i.e., to underwrite a national minimum and to equalize opportunities.

3. To compensate for lost revenue sources (taken over by the central government), or to compensate for new burdens imposed by the central government.

4. To relieve state and local taxes; or to lessen the burden on certain classes or groups of taxpayers.

5. To distribute income—i.e., to tax income concentrated in wealthier areas but derived from nation-wide operations, and distribute the funds so as to raise service standards and the productive capacity of persons living in the poorer areas of the country; more generally, to direct income flows throughout the various sectors of the economy in order to carry out a national economic policy.

6. To bring about a greater degree of co-ordination in federal, state, and local fiscal policies.

Two interrelated problems that merit attention are the administration of federal grants on the one hand and the administration of state and local services on the other. Clearly, the maintenance of reasonable standards of administration is of the utmost concern to the federal government as a protection against the unwise and improvident expenditure of federal aid. Experience indicates that the federal agency administering central aid may exert considerable influence in improving state and local administration by the insistence upon a merit system in personnel administration, by the provision of technical services and research, the building up of professional standards and techniques, the interchange of information and experience among the administrative officials of the several states, and in other ways.¹⁰

At the same time, in the administration of the federal grant program, care must be taken to avoid freezing irrational state and local adminis-

¹⁰ Joseph P. Harris, *op cit*, p. 26. See also the comprehensive study of V. O. Key, Jr., *The Administration of Federal Grants to States* (Chicago, 1937).

trative structures or blocking the execution of locally inspired policies and programs.¹¹ The complaint has been made that certain conditions attached to some federal grants (growing out of the regulations of the federal agencies which administer the grants) are phrased as if they were to operate in a vacuum and without regard for particularized local situations or for closely related functions of the units of government aided.

As long as a service is left to state or local administration, the maximum scope must be provided for the expression of the local will and for the adjustment of administration to local conditions. There is no conflict between the insistence by the granting government that its funds be wisely, economically, and efficiently expended on the one hand, and on the other hand the recognition by the federal administrative agencies that the state and local officials, responsible to the local voters, should retain full power to meet local conditions. Certainly the imposition of a generalized pattern of administration by a federal agency on all recipient units will produce undesirable results. It might be well to provide for a reviewing agency to which appeals could be brought by recipient units when an arbitrary regulation is imposed. In general, it is clear that if the grant-in-aid program is to be successful, it must be characterized by mutual respect and understanding, and a high degree of co-operation.

MEANS TO PROMOTE CO-OPERATION

In a complex federal system, where authority and functions are diffused, the attitude of officials with respect to co-operation at the various levels of government is of utmost importance.¹² The Treasury Committee on Intergovernmental Fiscal Relations, in its report, makes the following observation:

¹¹ For a concise statement of certain problems connected with grants, see Simeon E. Leland, "Some Observations in Intergovernmental Fiscal Relationships," *State-Local Fiscal Relations in Illinois* (Chicago, 1941), pp. 9-12.

¹² The discussion here is selective rather than inclusive. Many important devices of intergovernmental co-operation such as agreements and contracts, co-operative use of personnel, and administrative collaboration are not discussed. For a discussion of such devices, see Jane Perry Clark, *The Rise of a New Federalism* (New York, 1938), and U. S. Treasury Department, *Federal, State, and Local Government Fiscal Relations*, a Report Submitted to the Secretary of the Treasury by a Special Committee (78th Congress, 1st Session, Senate Document No. 69, Washington, 1943).

Much valuable energy has been wasted unnecessarily in quarreling over the proper spheres of the Federal Government and the States, when the seeds of solid achievement lie in the scantily tilled field of intergovernmental co-operation and co-ordination. Progress in this field requires some willingness to compromise, to surrender vested interests, and to forget jealousies on the part of both the Federal Government and the States. . . . The American governmental system has not been viewed as a unit by most public officials, with loyalties evoked and encouraged for the entire system.¹³

Our educational system, and especially the universities, should evolve courses of training which would furnish men and women entering government service—at whatever level—with an understanding of every level of government. It would be desirable, in this respect, to develop rotating internships which would provide students and certain picked administrators with practical experience at more than one level of government. Adult education should include courses for public officials on intergovernmental problems.

The problem of intergovernmental co-operation and policy co-ordination is a continuing one in a federal system. Constant study of and readjustments in intergovernmental arrangements are necessary. Formal machinery for administrative collaboration is extremely useful in assuring progress in this direction. Much has already been accomplished in the field of *interstate* co-operation through such organizations as the Governors' Conference and the Council of State Governments. Organizations of local officials—such as the American Municipal Association, the Mayors' Conference, the Municipal Finance Officers' Association, and the International City Managers' Association—have furthered intergovernmental co-operation and have served as clearinghouses of information. Although these groups have done much to sponsor collaboration between state and local units and the federal government, there is need for a formal mechanism through which a greater degree of intergovernmental fiscal co-ordination can be promoted.

An intergovernmental fiscal commission (or authority) has been recommended by a large number of organizations and individuals.¹⁴ Such a commission might perform the following functions:

1. Conduct research and report on (a) the financial interrelationship

¹³ U. S. Treasury Department, *ibid.*, p. 1.

¹⁴ See especially U. S. Treasury Department, *ibid.*, pp. 5-8.

of the various levels of government, including grants-in-aid, overlapping taxes, shared taxes, federal payments in lieu of property taxes on federally owned property, and the like, (b) tax administration, compliance costs, differential tax burdens as a factor in industrial location and relocation, and apportionment formulas under income and business taxes, (c) the economic and social effects of the fiscal activities of the various levels of government.

2. Promote better governmental reporting, accounting, and statistics.

3. Make recommendations with reference to the co-ordination of fiscal policy at all levels of government.

4. Act as a "board of appeals" to hear complaints pertaining to intergovernmental relations regarding such matters as administrative regulations and decisions in the execution of federal-aid acts, the adequacy of federal payments in lieu of taxes, and the use of taxation or other instrumentalities as interstate trade barriers.

5. Promote collaboration in the administration of taxes employed by both the federal government and the states; evolve techniques to avoid conflicts and promote the use of devices such as joint returns, joint audits, and joint use of personnel.

6. Supervise the Public Work Reserve.

The Treasury Committee on Intergovernmental Fiscal Relations has specifically recommended a Federal-State Fiscal Authority. It is suggested that the personnel of the Authority consist of one member appointed by the President, one selected by a conference of delegates named by state governors, or by the latter directly, and one named by these two, all to be suitably qualified in the field of intergovernmental fiscal relations. Terms would be staggered and of four years' duration. It is also recommended that this commission of experts should be assisted by a representative advisory council. The council would afford direct representation of congressional committees, and recognized organizations of state, local, and federal officials.

Another possible arrangement would be the setting up of an Intergovernmental Fiscal Authority, consisting of, say, seven members, appointed by the President with the advice of the major organizations of state and local officials, and with the consent of the Senate. Such an arrangement would avoid the serious difficulties involved in the selection of one representative for the 48 states, as well as the possibility of resentment on the part of local officials in not being directly repre-

sented at all. Moreover, a larger membership would permit a greater degree of representation of various interests and points of view on the board itself, and would permit a subcommittee arrangement, with different members concentrating on the various aspects of the problem of intergovernmental fiscal relations. Thus, three members might devote a large part of their time sitting as a "board of appeals," freeing other members to concentrate on such problems as tax co-ordination. It would be desirable for the Authority to appoint a director (general manager) to handle administrative details, to sponsor the research work, and to maintain constant contact with local, state, and federal agencies, and with officials' organizations.

Undoubtedly the success of an Authority of the kind recommended would depend in large measure upon the type of men chosen as well as upon the authority delegated to them. Unless they possessed a highly developed intergovernmental outlook, rather than a "states' rights" or "centralization" bias, the Authority would become ineffectual. Again, unless specific operational authority is granted it might well become a glorified report-writing agency. If an intergovernmental agency is to be set up at all, it should be given the tools with which to carry out significant and important tasks.

INTERGOVERNMENTAL INFORMATION

Intergovernmental fiscal policy co-ordination is difficult, if not impossible, without complete information concerning the financial plans, policies, and activities of governmental units at all levels. There has been in the past an unfortunate tendency for governments to pay inadequate attention to the fiscal programs of other units. New taxes are imposed, rates are changed, funds are borrowed, and money spent, very often without due consideration to the effect of such activities on other governments or, for that matter, on the national economy. Although knowledge alone cannot serve to bring about fiscal co-ordination, undoubtedly complete information and publicity concerning the policies and programs of all governments are essential if such co-ordination is to be achieved.

A great deal has already been accomplished in this direction. The work of the Division of State and Local Government of the United States Census Bureau is especially noteworthy. This agency brings to-

gether and makes available in usable published reports, data on the revenues, expenditures, borrowing, and employment of state, county, and municipal units. Special studies of such subjects as assessed valuations, grants-in-aid, trust-fund and public-pension systems are also prepared. Biennial studies of state budgets and analyses of governors' messages have recently been inaugurated. In order that a comprehensive picture of state and local fiscal programs might be available, the studies of the Division might well be extended to include (a) state tax proposals and legislation, (b) local budgets, (c) rates of the more important state and local taxes, and (d) an annual study of total governmental revenues and total expenditures. The preparation of a state-local yearbook—a compendium of all pertinent data—would be eminently desirable.

Many different federal agencies are collecting information from state and local governments.¹⁵ Although part of the information is for general use, most of the separate inquiries are for specific administrative purposes, and the data collected are frequently not known or made available to anyone outside the collecting agency. No consistency in concepts, definitions, or classifications among the inquiries of different agencies is now achieved, or usually attempted. Except by individual inquiries to each agency separately, it is impossible to discover what information is being or has been collected on state and local government transactions, activities, and plans. Some federal agencies collecting data for their individual purposes have field forces for intensive local surveys and investigations, which, when part of a federal-aid program, or when operating with war funds in defense areas, have special advantages and influence on local methods of keeping records. However, the influence and example of these different federal agencies in asking for the same information in divergent ways without reference to basic, general-purpose requirements retard, rather than encourage, unified and consistent local government records. In general, lack of a centralized or co-ordinated federal system for collecting, compiling, and making available information on state and local governments results in waste and inefficiency in collecting information, and also in minimum utilization of the data collected. These deficiencies

¹⁵ Alvin H. Hansen and Harvey S. Perloff, *State and Local Financial Data Compiled by, and Available at, Various Federal Agencies*, August 1941, 26 pp., mimeographed.

are the more serious because much of the data collected are appropriate for general use or could be made so if consistent definitions and classifications could be formulated.

Connected with the need for data on state and local governments is the need for supplementary information about the economic and sociological characteristics of special areas, especially urban areas, their situation and requirements in the war and postwar periods.

Suggestions for improvements include the following:

1. Designating a single agency (logically, the Division of State and Local Government of the Census Bureau) as the focal agency for information on state and local governments, whose functions would be, in addition to its own work of collecting and publishing general-purpose state and local government data (a) to know the specifications and extent of information in the same field collected by other federal agencies for their administrative purposes, and (b) to arrange, in co-operation with other federal collecting agencies, to maintain for public access at least summary compilations of the data collected by such other federal agencies.

2. Constituting a technical council in the field of state and local government data, made up of representatives of federal agencies which would consider questions of comparability, concepts, definitions, and classifications.

- 3 Encouraging uniformity in state programs for collecting local government information, at least to the extent of including minimum items on which general agreement could quickly be reached.¹⁶

The defects in the present situation are not only the concern of federal agencies collecting the information, but also of state and local government officials who are asked to supply the data. Multiple requests from different federal agencies for information on the same subject, but by different breakdowns and definitions, are obnoxious to state and local officials, even in peace time. In war times, when their offices are depleted in personnel, multiple conflicting federal canvasses are especially irritating to these officials.¹⁷

¹⁶ See Henry F. Long, "The Case for a Minimum State System of Local Government Reporting," *Proceedings, Conference of the Municipal Finance Officers' Association on State Supervision of Local Finance*, Washington, D.C., December 4, 5, and 6, 1941 (Chicago, 1941).

¹⁷ From a memorandum prepared by Dr. E. R. Gray, June 18, 1942, reporting on preliminary meeting, sponsored by Harold M. Groves and Harvey S. Perloff, on the subject of defects, deficiencies, and wasted opportunities in collection of state and local government information by federal agencies.

If intergovernmental fiscal co-ordination is to be fostered, it is necessary not only that the information be available, but also that it be analyzed in terms of developments within the economy. An Intergovernmental Fiscal Authority would be an appropriate agency to make such an analysis. Wide publicity should be given to both the material and the analysis. It would be useful, also, if the annual Budget Message of the President contained a comprehensive statement concerning the relation of federal fiscal programs and policies to the state and local governments.

REGIONALISM AND INTERGOVERNMENTAL RELATIONS

In a country as large as the United States, many programs and problems are peculiarly of regional significance. River-valley development, transportation integration, land use, industrial utilization of resources, and the like, involve the problem of administrative co-ordination at the regional level. Decentralization, within the pattern of a federal program, serves to encourage responsiveness to the needs of the people directly concerned, as well as intergovernmental collaboration and adjustment. Concrete mutual interests and physical proximity promote unified action by different levels of government. This fact has been impressively demonstrated in the Tennessee Valley, in the Columbia River basin, and in areas where agricultural, irrigation, and other federal programs have been carried out through decentralized administration.

The attitude of regional agencies toward intergovernmental co-operation is symbolized by a special, detailed report prepared by the Tennessee Valley Authority on "TVA Co-operative Relationships." It states in part:

By appropriate and precise measures of collaboration between the regional agency in the Tennessee Valley and the many federal, state, and local agencies, common problems are agreed upon, specific contributions of each identified, and the specific abilities of each agency thus brought to bear on its appropriate part of the problem. Complete co-operation and collaboration formalized in memoranda of understanding, formal agreements, contracts, and descriptions of joint programs have literally built a seamless web of concerted and efficient attention to the problems of the Tennessee Valley region and of the Southeast. The chief concern of the Tennessee

Valley Authority in all these co-operative programs is that wherever possible those parts of the joint program which require direct relationship with the people of the area be carried out by the agencies which those people support and control. In this manner, the region-wide program will inevitably be measured by the extent to which the participating public believes that its needs are being served by these many governmental activities. In this manner, also, a close companionship is developed between the technical and scientific personnel of our governmental agencies and the lay public which those agencies serve. Without this close companionship, the contributions of science, technology, and enlightened public administration cannot solve the problems which must be solved if they are to progress.

The Authority's co-operative understandings should therefore be assessed as a device for achieving the highest democratic relationships possible between agencies of public administration and the public that supports them and receives their technical contributions.¹⁸

The actual progress achieved through this approach toward the governmental process points to a significant advantage to be gained through a greater degree of decentralization within the sphere of federal activities. The federal government, operating through regional organizations, varying with the special conditions of different areas, can promote higher efficiency in local government, more adequate social-service standards, and a greater degree of intergovernmental co-operation.

¹⁸ *TVA Co-operative Relationships*, June 1942, 54 pp., mimeographed, pp. 1-2.

Chapter Eight

FEDERAL UNDERWRITING OF MINIMUM SERVICE STANDARDS

A RATIONAL distribution of administrative and financial responsibilities among the various levels of government is essential in order to establish a sound foundation for state and local fiscal structures. To achieve the objectives that have been set forth (satisfactory service standards, equity in tax burdens, and economically sound fiscal policy) there is need for a closer approximation to the principle that governmental functions should be assigned to those units that can most effectively perform them, and that taxes should be levied by the governmental units capable of assessing and collecting them effectively. We can hope to approximate this ideal only if the federal government accepts the responsibility for underwriting a national minimum for essential social services. In some instances this would involve a shift from state or local administration to federal administration; in most instances it would involve the extension of federal aid to states and localities. The underwriting of a national minimum for the more important and expensive services would not only make possible the realization of satisfactory standards but would also enable the states and localities to rationalize their fiscal structures.

Education, social security, and health are now accepted as social responsibilities. In fact, in recent years these services have accounted collectively for the bulk of nonmilitary public expenditures. These services must be supported; the only question that remains is whether or not the federal government should underwrite minimum programs and insure that the minimum standard be provided everywhere without an undue strain upon local resources.

The case for a national minimum seems to us to be incontrovertible. On the one side, there is a direct national interest in each of these services. On the other side, a large number of states and localities do not have the economic resources necessary to finance these services at a satisfactory standard.

It should be noted that the services for which national minima are urged are concerned with our most vital resource—the people. The critical war period has disclosed serious educational, physical, and mental defects. We have failed to develop adequately our human resources. This problem is not confined to any single community or state; it affects the entire nation.

Consider the question of education. We know that a large number of states and localities with extremely limited financial resources cannot adequately support their schools. And yet it is precisely in these areas that we find the largest proportion of children. It is in the rural regions of the South that the birth rate is highest. Yet these regions have the least to offer for the intellectual development of youth.

With the degree of mobility that is reasonably certain to characterize the American people in the future, it is no longer possible to regard education as essentially a local or even a state concern. For good or ill, young migrants enter into the economic, social, and political life of the communities in which they spend their mature years, wherever they go they carry with them their cultural heritage, their knowledge or ignorance, their occupational adjustability or lack of it, and their ability or inability to participate wisely in the determination of social policy. No state and no region that is concerned with its own safety and its own welfare can be indifferent to the educational opportunities afforded youth in those states and regions from which it will draw in large proportions its future citizens.¹

In recent years internal migration has been at a high rate. The length and breadth of the country is now the labor market. The average distance traveled by migrants to find work in the San Diego war boom was 1,100 miles. In the decade of the 1920's there was a net movement of over six million people from farms to urban communities.² The 1940 census revealed that 12.5 per cent or one-eighth of all family heads were migrants.³ The migratory pressure is, in general, from the

¹ Newton Edwards, *Equal Educational Opportunity for Youth*, American Council on Education (Washington, 1939), p. 136.

² 19.4 millions left the farms while 13.1 millions went to the farm from the urban areas. Select Committee to Investigate the Interstate Migration of Destitute Citizens, *Report on Interstate Migration*, House Report No. 369, 77th Congress, 1st Session, April 3, 1941, p. 287.

³ U. S. Bureau of the Census, 16th Census of the U. S., *Population and Housing*, "Family Composition, and Migration Status of Family Head, for States 1940"—Series PH-4, No. 2, April 16, 1943. Migrants are defined as persons

poorer areas with the lowest educational and health levels to the richer areas.⁴

The cost of educating the youth falls unequally upon the rural and poorer areas of the country. When the young people migrate to the cities, they contribute to the productivity and prosperity of the metropolitan area.⁵

During the war the federal government has found it necessary to subsidize education in certain areas. The shortage of skilled workers, nurses, and technicians of all sorts has necessitated extensive training programs. The army has assigned badly needed personnel to teaching the alphabet. Education to enhance the productivity of its workers is a national responsibility.

For the welfare of the nation as a whole, it is essential to develop an intelligent citizenry, able to read and discuss public issues with discrimination and judgment. This is the price of the survival of democracy. The national government cannot be indifferent to the quality of popular education. The complex issues of government make it increasingly imperative that the nation be composed of enlightened citizens.

The case for a national minimum in health and welfare is equally strong. The elimination of mass unemployment would undoubtedly go a long way toward the realization of the goal of a satisfactory standard of security for all; nevertheless want and insecurity would remain. It

whose 1935 residence and 1940 residence were in different counties, or who moved to or from a city of 100,000 or more within the same county.

⁴ "Southern farms contributed about 6 per cent of the migrants, and one-third of these were Negroes. Georgia and Texas were each responsible for more than a half million. The 12 Western States, on the other hand, accounted for only 4 per cent of the net migration from farms. The remaining 36 per cent came from the Northern States cornered by Maine and Maryland, and North Dakota and Kansas." *Report on Interstate Migration*, p. 182.

⁵ "The cost of the contribution which the farming people have made to the productivity and the prosperity of cities, suburbs, and villages is greater than is commonly recognized. This cost has fallen with especial weight on the less commercial farmers. If it costs \$2,000 to \$2,500 (at predepression prices) to rear and educate the average child on American farms to the age of 15, when he may be assumed to be self-supporting (and \$150 a year does not seem an excessive estimate of the cost of food, clothing, medical services, education, and all the incidental expenses), the 6,300,000 net migration from the farms during the decade 1920-1929 represents a contribution of about \$14,000,000,000. This contribution is almost equal to the value of the wheat crops plus half that of cotton crops during these years." O. E. Baker, "Rural and Urban Distribution of the Population in the United States," *The Annals of the American Academy of Political and Social Science*, Vol. 188 (November 1936), pp. 271-272.

is well known that even in times of high business activity, a part of the population does not enjoy what may be called a minimum standard of living, however high the total national income may be. Some persons are temporarily out of work. Others are sick or disabled or too old or too young to work. Still others, due to insufficient education and training, or for other reasons, earn too little even when they do work. Advanced democracies, especially one so rich as ours, cannot escape responsibility for these groups.

The fact that it is definitely in the interest of the community as a whole to eliminate this want and insecurity is not so well understood. In the final analysis, the prosperity and welfare of the nation depend on the productive abilities of its members. Adequate facilities for health, education, and vocational training, provisions for unemployment, disability, and old age, aid to dependent children, and other similar measures appear at first glance to be very expensive. Yet it can, we believe, be demonstrated that the benefits derived by the community will more than repay the costs. Some discussion of the economics of this problem is given in Chapter IX.

The establishment of minimum service standards presents many difficult problems. The most direct method for providing a national minimum is, of course, federal administration. In the case of the social-insurance program this is, we believe, the most rational method. In the case of education, health, and public welfare, however, federal administration of the service is not a practical solution in the United States. Tradition, the necessity of adjustment to particularized local conditions, and the desirability of direct responsibility to local voters, all militate against such a solution. In fact, in the case of education, the greatest obstacle to the expansion of federal aid has been the fear of federal control. What is needed, then, is the distribution of federal financial assistance in such a manner as to permit the provision of satisfactory standards in education, health, and public welfare, but without undue federal control over the actual administration of these services. This can be accomplished through the use of "equalization" grants.

The problems involved in each of these services vary and a somewhat different solution is called for in each instance. However, several principles must apply throughout. In brief these are:

1. Grants should be distributed to the states on the basis of relative need and relative financial resources—that is, those with the greatest

need and least resources should receive the largest per capita grants, and those with the least need and greatest financial capacity should receive the smallest per capita grants, so that each governmental unit may provide the minimum program without an undue strain on its resources.

2. The federal funds distributed should be sufficient to permit satisfactory service standards throughout the entire nation.

3. The grants should be distributed in a manner to stimulate the state and local units to make a reasonable effort to support the services out of their own resources. Care should be taken that lack of interest or of effort on the part of states and localities should not be encouraged by subsidy.

4. The federal aid should be distributed in such a manner as to permit full opportunity for the states and localities to achieve a balance in the support of their various functions and to make adjustments to particular local situations. This problem was discussed in a previous chapter.

5. Consideration should be given to existing arrangements and commitments in each of the fields under consideration both at the federal and at the state and local levels. Thus, for example, it is doubtful whether the federal grants now being distributed to rich and poor states alike could be reduced without undesirable repercussions even if a reduction in the case of the richest states might be justified by a rational equalization program. The present division of service responsibilities and financial arrangements between the states and the localities should certainly be taken account of in the development of an expanded national program.

A MINIMUM FOUNDATION PROGRAM FOR EDUCATION

It is generally agreed that at least a minimum educational program should be provided in every community in the United States. It is, of course, difficult to estimate the precise magnitude of such a minimum program. On the basis of the best estimates now available, however, it appears that an adequate educational program throughout the United States would require an annual expenditure for elementary and secondary education of some \$3½-\$4 billion (at current prices). In 1941,

the total annual outlays on the public-school system amounted, in round figures, to \$2.4 billion for current expenses, and about \$200 million for capital outlays. For a decade or so after the war these sums should be raised to about \$3.5 billion and \$400 million⁶ respectively in order to achieve a satisfactory educational program throughout the entire nation. Since with very few exceptions the states and localities are already making a serious effort to support education, it may be concluded that the federal government will have to assume the great bulk of the increase from the present levels to the desired levels. We estimate, therefore, that the federal government should distribute between \$1 billion and \$1¼ billion in support of elementary and secondary education, including both vocational and general education, school construction, teacher training, and preschool education (nursery schools and kindergartens).

The basis upon which federal aid for education should be distributed has been carefully studied by a number of private and public agencies, and by individuals. From these studies, especially that of the President's Advisory Committee on Education, certain principles have evolved. Four are particularly important:

1. The major portion of all federal aid for education should be granted as a general fund for the current support of elementary and secondary education. In order that states and local school jurisdictions may have the necessary flexibility in the development of programs suited to local conditions, the specification of particular phases of elementary and secondary education to be supported from such a fund should be avoided. The federal government should record its purpose explicitly but broadly, leaving to the states wide discretion and flexibility in the administration of the federal grants, although those grants should be conditioned upon distribution within the states in conformity with the general principles for which the grants are made. Special aids may, however, be necessary. For example, it may be desirable to

⁶ These figures may be compared with an estimate of six or seven billion dollars needed to carry out a 10-year program of school construction—to keep abreast of population shifts and changes, and to replace obsolete, substandard, or poorly located schools. See estimates contained in U.S. Office of Education, *Planning Schools for Tomorrow*, Leaflet No. 64 (Washington, 1942); The Advisory Committee on Education, *The Land-Grant Colleges Staff Study No. 19* (Washington, 1939); and the estimates of Floyd W. Reeves in National Resources Planning Board, *National Resources Development, Report for 1943, Part I* (Washington, 1943), p. 73.

promote the reorganization of school districts or the encouragement of certain phases of the educational program, such as teachers' colleges and the creation of adequate research agencies. There is no fundamental objection to the supplementary use of special aids provided they do not displace a sound and adequate system of general support upon which the states and localities should be able to build on their own initiative.

2. In order that local initiative and responsibility may be maintained, all federal action should reserve explicitly to state and local auspices the general administration of schools, control over the processes of education, and the determination of the best uses of the allotment of federal funds within the types of expenditures for which federal funds may be made available. Federal agencies should in no case attempt to control the curricula of the schools, the personnel, materials of instruction, or the methods of teaching to be employed. The federal government should, however, carry on research with respect to these problems, and make the results widely available to local governmental units.

3. Federal aid for education should be granted on a basis that would lessen inequalities of opportunity among the states and within states. Allotments by state departments of education to local school jurisdictions should be determined by the use of formulas based upon objective data which measure relative need and financial ability.

4. All federal grants for educational purposes to states maintaining separate schools and institutions for negroes should provide an equitable distribution of the federal funds between facilities for the two races.⁷

Numerous proposals for federal aid to education have been made in recent years. Of special import is the program suggested by the Advisory Committee on Education after an exhaustive survey of the subject of federal support. This program, in broad outline, was incorporated in a bill, S. 1305, introduced in the First Session of the 76th Congress. The bill proposed the distribution of federal grants for education, expanding gradually from \$75 million in 1940 to \$208 million in 1945. Allocation of the grants was based on an index of "financial need" determined by the relationship of an index of educational

⁷ The Advisory Committee on Education, *Report of the Committee* (Washington, 1938), Ch. III.

load (children 5 to 19 years of age, each rural child being weighted 1.4) and an index of financial ability (to be determined by the Secretary of the Treasury, using the yield of a uniform tax plan or comparable economic indices). In addition to general elementary- and secondary-school aid, the bill proposed additional aid of lesser amounts for teacher preparation, building construction, state education departments, adult education, rural libraries, co-operative educational research, and education of children on federal reservations. The grants were conditioned on (a) no reduction in school expenditures from state funds, (b) an equitable distribution of funds to schools maintained for minority races where separate schools are provided, and (c) distribution of funds among local school jurisdictions "in such manner as to assist effectively in equalizing educational opportunities" in schools within the state.

A more recent bill,⁸ introduced on February 4, 1943, proposed federal aid "to assist the States and Territories in more adequately financing their systems of public education during emergency, and in reducing the inequalities of educational opportunities through public elementary and secondary schools." For the former purpose, \$200 million a year was proposed; for the latter, \$100 million. The grant to assist states in meeting "emergencies" in financing schools was to be apportioned to each state on the basis of the ratio of average daily attendance of public-school pupils within the state to national average daily attendance. Allocation of the "equalization" grant was to be based on an index of financial need for each state. This index was to be computed by determining (a) the percentage of children 5 to 17 years of age within the state, of total children of this age in the United States; (b) the percentage of income payments within the state of total national income payments. The excess, if any, of the first percentage figure over 65 per cent of the second percentage figure would be the index of financial need. The per cent which this figure represents of the sum of corresponding figures for all states gives the per cent of the total equalization grant to which the state in question would be entitled. The grants were to be conditioned, among other things, on no reduction in public school expenditures from state funds, and on provisions for an equitable apportionment of the funds for the benefit of public schools maintained for minority races in the states where separate schools are maintained. In view of the strong opposition to federal educational aid

⁸ S 637, 78th Congress, 1st Session

from various quarters, it may be politically necessary to propose federal aid on the extremely conservative scale suggested. While a small beginning is preferable to no federal support whatsoever, it is nevertheless important to realize that the grants proposed in these bills would fall very far short of the equalization and maintenance of minimum satisfactory standards of educational opportunity throughout the nation. To provide a justifiable minimum educational program in the postwar period, federal aid amounting to a billion dollars annually will be needed. Undoubtedly it would be desirable to expand federal aid gradually over a number of years so as to permit adjustment by the states and the local school jurisdictions to the enlarged educational program. Nevertheless, as soon as it can be accomplished without waste and maladjustments, federal aid should reach a level sufficient to provide a solid foundation of support for a national minimum program.

Each of the education-aid bills contains provisions which deserve very careful attention in the development of a federal program. The more recent legislative proposal has made some noteworthy improvements over its predecessor, but at the same time it has omitted several provisions therein contained which appear to be important in a rounded program of federal aid. In general, the more important considerations are:

1. The use of total daily attendance as a basis for apportionment. The use of such an index as compared with an index based on the number of children of a given age (such as 5 to 17) would be advantageous from the standpoint of encouraging state and local school units to maintain high records of attendance by providing for longer school terms (in many areas the school term is far too short) and by encouraging student attendance.

2. The weighting of rural children in the index of educational load. Educational costs are higher in the country than in the city for comparable programs, either because of smaller classes or, if the schools are consolidated, because of additional transportation costs. Studies of school costs indicate that each rural child should be given the weight of 1.4.⁹

3. The use of income payments to measure relative state fiscal ability.

⁹ *Hearings, Sen. Comm. on Education and Labor on S. 1305, "Federal Aid to Education Act of 1939," 76th Congress, 1st Session (Washington, 1939), pp. 50-51.*

Although such a measure has certain shortcomings, it is the most promising suggestion made to date. As compared with other proposed measures—such as a comparison of the estimated yields of a uniform tax system in the different states, or a combination of various statistical series bearing on certain manifestations of wealth and income in each state—the use of per capita income in the states as an index of relative fiscal capacity is more objective, easily calculated, and more readily comprehended.¹⁰

4. Conditioning the federal grants on approved state "equalization" plans of distribution. The objectives of the national minimum foundation program cannot be achieved unless satisfactory intrastate equalization plans are developed. If a state employs per capita distribution or proportional matching grants, the purpose of federal variable grants may be defeated and disparities in educational offerings may be intensified. Although many states now have highly developed equalization programs, in the majority of states the proportion of equalization grants must be increased, while per capita and other methods of distribution must be minimized in order to achieve the objectives of a federal minimum foundation program. Federal approval of state distribution systems as a condition of federal aid need not require the adoption of a uniform plan by all the states. State plans for distributing both state and federal funds should, however, promote the federal objective of equalizing educational opportunity.¹¹

5. Provision of a separate grant for school construction, primarily in connection with reorganization of administrative units and attendance areas. The obsolete type of school-district organization which still persists in most states is extremely wasteful and is in part responsible for poorly trained and poorly paid teachers, limited courses of study, lack of constructive supervision of teachers, unsatisfactory school buildings, and many other deficiencies. The existence of such school districts makes the task of equalization difficult if not impossible. The Advisory Committee on Education has pointed out that few reforms are more urgently needed in American education than a considerable reduction

¹⁰ See the excellent study of Paul Studenski, *Measurement of Variations in State Economic and Fiscal Capacity*, Social Security Board, Bureau of Research and Statistics Memorandum No. 50 (Washington, March 1943).

¹¹ See U. S. Treasury Department, *op. cit.*, pp. 552-569, The Advisory Committee on Education, *The Extent of Equalization Secured through State School Funds*, Staff Study No. 6 (Washington, 1938).

in the number of small school districts and the organization of larger administrative and taxation units. District reorganization and school consolidation are so closely associated that the two major obstacles are likely to be the cost of the necessary new school buildings and the cost of transporting the pupils after the establishment of central community schools. The "general" federal grant should provide, among other things, for transportation; and a special construction grant should provide the necessary buildings, conditioned on the reorganization of administrative units and attendance areas. It is logical for the federal government to safeguard its funds against dissipation by administratively unfeasible units. The grant should insure the integration of school-building construction with other construction programs in keeping with the requirements of the economy.

Although the principles involved in the distribution of federal aid for education have been greatly advanced by the legislative proposals discussed above, a number of important problems underlying the provision of a national minimum foundation program still remain to be solved.¹² Possibly the most important of these is the maintenance of educational standards in periods of depression, when state and local finances may be severely strained. In the past, public-school expenditures have been sharply curtailed in depression. Some degree of flexibility in federal support is necessary in order to maintain the minimum foundation program.

SOCIAL SECURITY

We have made an important beginning in the development of social insurance and public-assistance programs. Nevertheless, much remains to be done to provide inclusive protection against want due to old age, dependency, sickness, disability, and unemployment.

Analyses of the present system of social insurance have revealed a number of serious shortcomings. Too small a part of our population is covered by the old-age and unemployment provisions. The groups excluded from protection are chiefly those that are most insecure in our present-day society—for example, agricultural workers and do-

¹² The federal government might well establish, jointly with the states, a number of regional honors academies in order to provide superior high-school training for gifted students. Only students who had won scholarship by regional competition would be admitted to these honors academies.

mestic servants. Excluded also are the employees of small establishments.

The size of benefits is generally too small to provide even for subsistence living, and the duration of benefits too short. Needy individuals who are not covered by the insurance system receive inadequate public-assistance payments or no payments at all in many areas of the country. Finally, our social security system offers no protection against certain risks, such as sickness and nonindustrial disability. Before the war, there were only three countries in Europe which did not provide some form of health insurance. The United States has also lagged behind other industrial countries in maternity benefits and in the care of infants.

It is now widely accepted that in order to provide for social security consistent with the concept of a national minimum, and commensurate with our productive capacity, a comprehensive program needs to be developed involving three basic elements, namely.

1. A unified system of *social insurance* covering (a) old age and survivors, and permanent disability, (b) unemployment and temporary disability, and (c) hospitalization and medical care.

2. Cash *public assistance* to provide (a) for the needy who do not qualify for benefits under the insurance system, including the aged, the blind and otherwise disabled, and dependent children, and (b) general relief for other needy individuals and families. A single general welfare category is preferable to differential treatment of a number of special categories.

3. Provision for *direct public services and facilities*, including public health services and clinics, special and general hospitals, institutions of various kinds, vocational rehabilitation, and nutrition.

SOCIAL INSURANCE

The essence of social insurance, as Sir William Beveridge expressed it, is a redistribution of income.¹³ To the extent that the cost is financed by contributions from future beneficiaries, the redistribution of income takes place over time. If, as is usually the case, part of the cost is borne by the employers, or the general public, a redistribution of

¹³ Sir William Beveridge, *Social Insurance and Allied Services*, American Edition (The Macmillan Co., New York, 1942), p. 167.

income between various groups is effected. A more complete discussion of these problems will be attempted in the section on the financial aspects of the program.

No unified system of comprehensive social insurance exists in the United States today. We have a federal old-age and survivors-insurance system, and state-operated unemployment insurance. Industrial accidents and diseases are covered separately under various state workmen's compensation laws. There is no general compulsory health insurance. Large groups of our population belong to no insurance system at all. Others, such as railroad, federal civil service, and certain state and municipal employees, are members of special systems. The benefits received by the vast majority of participants are too low even for a minimum standard of living and their duration is often too short. A more detailed examination of the problems involved and suggestions for their solution follows:

(1) *Old Age and Survivors and Permanent-disability Insurance.*—The organization of old-age and survivors insurance may be said to be relatively satisfactory. It is completely operated by the federal government, thus escaping the special problems of interstate relations which beset the state-operated unemployment insurance. Old-age and survivors pensions also have special benefits for dependents which the unemployment benefits usually lack. But there is still room, and even acute need, for improvements.

The most glaring defect of our old-age and survivors insurance is its limited coverage. A large part of our population, who will certainly need old-age pensions, are excluded by law, including agricultural and domestic workers, employees of nonprofit institutions, self-employed persons, and public employees. Some 15 or 16 million additional individuals could well be covered by the system.

The extension of old-age insurance to include nearly every citizen of the country is a practical goal. The use of stamp books would facilitate the collection of premiums from domestic servants, agricultural and other workers. There is no reason, moreover, why self employed persons and employers should be excluded, particularly if they express a *desire to become members*.

The average primary monthly benefits to the insured workers in

November, 1942, amounted to \$22.95; those of wife and child to \$12.21 and \$12.19 respectively.¹⁴ An increase in these benefits due to higher wage rates and special provisions of the law can be expected in the future. Under the existing legislation, the maximum monthly amount which a single member who has been contributing for 40 years can ever hope to receive is \$56, and most of the recipients could never qualify for this amount. Liberalization of benefits should be adopted.

The existence of a large number of noncovered employments often results in inequitable treatment of workers moving from one occupation to another. Some of these workers "who work in both covered and noncovered employment will fail to qualify or will qualify only for minimum old-age and survivors insurance benefits because only their earnings in covered employment, rather than their total earnings, are credited in the computation of their benefit rights."¹⁵ To the extent that workers are aware of this situation, it may interfere with labor mobility between different employments. Naturally the larger the part of our population covered by insurance, the less will this difficulty prevail. An intersystem wage credit should be given to workers moving from employments covered by one system to those covered by another; thus no impairment of benefit rights would occur.

Finally, old-age and survivors insurance should be supplemented by a provision for permanent disability due to nonindustrial causes. A disabled person is very often as helpless as an old one, but under present conditions he cannot qualify for a pension before he reaches the age of 65 unless his disability was caused by an industrial accident or industrial disease.

(2) *Unemployment and Temporary-disability Insurance.*—Considerable progress has been made in the field of unemployment insurance by reason of the enactment of the Social Security Act in 1935. A large part of our working population has been relieved from at least a part of the insecurity arising from unemployment. Valuable experience in dealing with the problem has been accumulated, but present provisions are inadequate.

Our unemployment insurance is a combined federal-state under-

¹⁴ *Social Security Bulletin*, Vol. 6 (February 1943), p. 49, Table 2.

¹⁵ Social Security Board, *Unemployment Compensation Rights of Workers Employed in More Than One State* (Washington, December 1941), p. 1.

taking, with the states playing the major role. The federal government imposes a 3 per cent tax against employers of eight persons or more. The proceeds are used to assist the states in meeting the administrative costs of the program. State payroll taxes, deductible to the extent of 90 per cent of the federal 3 per cent tax, amount in practically all states to 2.7 per cent of payrolls. Only a few states impose a tax on employees as well. Eligibility rules, amount and duration of benefits, are determined by the states.

The fundamental weakness of our unemployment-insurance program is its insufficient coverage. Certain fields such as agricultural labor, domestic and maritime service, employees of nonprofit organizations, government employees and some others are specifically excluded from the federal law; workers in establishments employing less than eight persons (for 20 weeks) are excluded as well. The states have, in general, followed the federal exclusions, with numerous individual variations.¹⁶

The specific problems created by the existence of covered and non-covered occupations, as well as by the presence of several systems of insurance, have already been discussed in the section on old-age insurance. Much of the argument applies to unemployment insurance as well. Thus it has been estimated "that because their earnings were divided between two unemployment-insurance systems 146,000 or 7.3 per cent of the two million employees with railroad earnings in 1937 would have suffered losses in benefits had they become claimants in the following year."¹⁷ These losses in benefits caused by shifts from one employment to another are not only unfair to the workers concerned, but may also interfere with mobility of labor which will be so important during postwar reconstruction. There is no good reason for the exclusion of workers employed in agriculture, domestic, or maritime work, as well as of the employees of small establishments and nonprofit organizations. Just as in the case of old-age insurance, the use of

¹⁶ Social Security Board, *Comparison of State Unemployment Compensation Laws as of December 31, 1941*, Employment Security Memorandum No. 8, revised December 1941, p. 11. This question will be further discussed in connection with the general problem of the administration for unemployment insurance. Cf. Committee on Long range Work and Relief Policies, National Resources Planning Board, *Security, Work, and Relief Policies* (Washington, 1942), p. 212.

¹⁷ Social Security Board, *Unemployment Compensation Rights of Workers Employed in More Than One State* (December 1941), p. 6.

stamp books could make their inclusion administratively possible. And similarly, if several systems of unemployment insurance are to be retained, an arrangement should be made to preserve for the workers moving from one employment to another the full benefits to which they would otherwise be entitled.

This widening, so to speak, of our unemployment-insurance system should be accompanied by its extension in depth. Even those of our workers who are fortunate enough to be included in the existing system have a very thin protection against unemployment. State unemployment laws show considerable variation in regard to amount of benefits and their duration. The amount of benefits is usually computed on the basis of wages received, with a specified maximum and minimum amount. Thus on February 18, 1943, the maximum amount ranged from \$20 per week in 4 states to \$15 in 26.¹⁸ But the average payments per week have been much smaller. The average weekly total unemployment benefits in the year 1941 were below \$7 in 2 states, and below \$9 in 15 states. Only 5 states paid more than \$13 per week.¹⁹

These benefits are insufficient for the maintenance of even the minimum standard of living, particularly for workers with low wages who cannot qualify for the maximum compensation. Liberalization of the benefits is necessary.

The maximum duration of benefits in the 47 states with a definite limit ranged (on February 18, 1943) from 20 weeks in 8 states to 13 weeks in 1 state; the majority (26 states) having a 16-week limit.²⁰ But in the majority of states the duration of benefits depends on the worker's prior earnings so that many workers cannot qualify for the maximum period. Existing studies indicate that a large percentage of unemployed workers exhaust their benefits before finding new employment.

The extension of the benefit period to at least 26 weeks is highly desirable. Sir William Beveridge has recommended, in fact, that no limits be imposed at all on the duration of benefits—but with a precaution.²¹

¹⁸ Social Security Board, *Significant Provisions of State Unemployment Compensation Laws, February 18, 1943*, I.S.C. 57, printed table.

¹⁹ These figures do not include compensation for partial unemployment. *Social Security Yearbook 1941*, p. 212, Table 35.

²⁰ Social Security Board, *op cit*.

²¹ "To reduce the income of an unemployed or disabled person, either

Adequate opportunities for vocational education in general and for retraining of workers having an obsolete skill must be provided. Without these, the program of unemployment insurance will not give the best results. It may even be necessary to make attendance at a retraining center compulsory for workers whose present skills are not in demand, particularly if the duration of unemployment is prolonged.

A very important defect of our unemployment insurance is the unavailability of any benefits during periods of temporary disability or illness. Some disabilities—those caused by industrial accidents and industrial diseases—are indeed covered by a separate system of workmen's compensation, but other types are not. A sick or disabled person cannot qualify for unemployment benefits since he is not available for work. Nonindustrial disease or disability should be taken care of by health insurance.

Special problems are caused by the state administration of unemployment insurance. In brief, the absence of a unified system imposes additional hardships on some workers, may create financial difficulties for the states, and results in unnecessary duplication of work both for state agencies and particularly for employers doing business in more than one state.

We have already considered the fact that the weekly unemployment benefits show considerable variations among the states, ranging on the average (in 1941) from \$5.90 in North Carolina to \$14.57 in California.²² This variability cannot be fully explained by wage differences

directly or by application of a means test, because the unemployment or disability has lasted for a certain period, is wrong in principle. But it is equally wrong to ignore the fact that to make unemployment or disability benefit, which is adequate for subsistence, also indefinite in duration involves a danger against which practical precautions must be taken . . . The danger of providing benefits, which are both adequate in amount and indefinite in duration, is that men, as creatures who adapt themselves to circumstances, may settle down to them. . . . The correlative of the State's undertaking to ensure adequate benefit for unavoidable interruption of earnings, however long, is enforcement of the citizen's obligation to seek and accept all reasonable opportunities of work, to co-operate in measures designed to save him from habituation to idleness, and to take all proper measures to be well. The higher the benefits provided out of a common fund for unmerited misfortune, the higher must be the citizen's sense of obligation not to draw upon that fund unnecessarily." Sir William Beveridge (by permission of the Macmillan Co.), *op. cit.*, pp. 57-58

²² *Social Security Yearbook* 1941, p. 212, Table 35.

in the several states. To a great extent it is due to differences in benefit formulas. Thus, "a worker whose high-quarter earnings and annual earnings are \$400 and \$1,000 respectively, would get a weekly payment varying from \$11 to \$17 and total benefits varying from \$100 to \$400, depending upon the State in which he earned his wage credits."²³ Eligibility requirements also vary considerably among the states. These variations are quite unfair to workers who live in states with less favorable benefit provisions. On the other hand, as will be shown later, the existence of separate state unemployment-insurance reserves could easily make the liberalization of benefits financially embarrassing, at least for some of the states.

It has already been shown that the existence of several systems of unemployment insurance, as well as of occupations not covered by any insurance at all, results in a loss of wage credits for workers moving from one employment to another. This situation is aggravated by insufficient co-operation among the states in regard to workers employed in more than one state. At present, if a worker qualifies in at least one state, he receives the benefits, even though he may be residing in another. Also (in the majority of states) if he has worked in several states, his earnings are added and he is insured in the state where the major part of his services are performed or where he resides, provided his whole work is done for *one* employer.²⁴ But if he has been employed by different firms, no such summation of his earnings in different states is made. As a result, the worker may not be able to qualify for benefits in any one state, in spite of the fact that his total earnings, if added, may be sufficient to qualify him in some one state. And if he should qualify in one state, the division of his earnings among several states is likely to reduce the amount and duration of his benefits. The actual loss will depend on the provisions in the laws of the particular state or states where he has qualified. On the other hand, there may be cases when employees with sufficiently high earnings will gain from the division of their wage credit among several states if the total benefits to which they are entitled exceed the maximum which they would receive if all their earnings were made in one state.

²³ Social Security Board, *7th Annual Report Fiscal Year 1941-42* (Washington, 1942), p. 16.

²⁴ Social Security Board, *Unemployment Compensation Rights of Workers Employed in More Than One State* (December 1941), pp. 1-2.

It is clear that on the whole considerable hardship is imposed on workers who migrate from one state to another. One study, for instance, indicates that from 3.5 to 13.6 per cent of such workers who would be entitled to benefits under a single unemployment-insurance system were disqualified because their earnings were made in more than one state.²⁵

A sample study made in Michigan has revealed "that 73.6 per cent of the interstate claimants, as compared with 45.8 per cent of all claimants whose benefit year began in 1938, exhausted their benefit rights and presumably remained unemployed. The Michigan Unemployment Compensation Commission concluded that a large part of the group of interstate claimants received very inadequate protection from the unemployment-compensation system, even when they were able to qualify for benefits."²⁶

This inequitable treatment of migrating workmen has no justification. It interferes with labor mobility already hampered by the existence of several unemployment insurance systems (such as for railroad, government employees, etc.) and noncovered employment in general. A worker moving across the state line very often loses wage credits. If he becomes unemployed, he will likely receive lower and shorter benefits. Often he cannot qualify for any benefits at all. Moreover, general relief—the only assistance available when unemployment insurance is exhausted—is usually restricted by fairly long residence requirements. The unemployed worker may thus be unable to get any help whatsoever. Knowing this, he may refuse to migrate. Thus the development of local "stagnant pools" of labor is encouraged. These pools may exist for long periods of time. Every measure must be taken to eliminate them. A unified unemployment insurance system would be an important step in that direction.

The existence of separate state unemployment-insurance systems creates special financial problems, the most important being the solvency of insurance reserves. Under the present arrangement, every state maintains a separate reserve with the Federal Treasury. In November, 1943, the combined balance of all state reserves was \$4.6 billion.²⁷ But considerable variations exist among the several states. The ratio of

²⁵ *Ibid.*, p. 22.

²⁶ *Ibid.*, p. 3.

²⁷ *Social Security Bulletin*, Vol. 6 (February 1943), p. 39, Table 5.

total benefits paid thus far to cumulative collections and interest through June, 1943 (see Table 35) ranged from 6.5 per cent in Hawaii, and 18.7 per cent in Delaware, to 48.5 per cent in Michigan, while the national average was 34.2 per cent.²⁸

TABLE 35 Ratio of Total Unemployment Compensation Benefits Paid to Cumulative Collections and Interest through June 1943

Per Cent	No. of States
5.0 and under 15.0	1
15.0 " " 25.0	10
25.0 " " 35.0	17
35.0 " " 45.0	19
45.0 " " 55.0	4

Source: *Social Security Bulletin*, Vol. 6 (August 1943), p. 37, Table 4

The amount of unemployment compensation available *per worker* in the accumulated funds showed considerable variation among the states, ranging (on June 30, 1943) from \$31.52 in Mississippi and \$28.61 in Florida to \$151.39 in New Jersey, the national average being \$98.71.²⁹ These figures are, however, somewhat misleading, because the amount of compensation to which the unemployed workers would be entitled also shows considerable differences. If the funds available for unemployment benefits per worker in each state (on June 30, 1943) are divided by the total average weekly compensation payment per worker in the year 1942 (the latest period for which figures are available), we can obtain a rough approximation of the average number of weeks of compensation available for each worker, as shown in Table 36. The table, of course, tells us nothing about how long each state fund could withstand the strain of depression since that would be determined by the proportion of covered workers who became unemployed. While the table does not disclose in any way the adequacy or inadequacy of the various state funds, it does present a picture of the wide variation in the magnitude of the current reserves per insured worker.

This unequal distribution in per worker reserves could easily result in the financial collapse of some of the state unemployment-insurance funds, particularly if unemployment struck hard in the states with weak funds. As we have seen, existing benefits are quite inadequate

²⁸ *Ibid.*, Table 6

²⁹ Social Security Board, *8th Annual Report 1943*, p. 97, Table 9.

TABLE 36. Average Number of Weeks for Which Funds Available on June 30, 1943 Would Provide Unemployment Compensation

No. of Weeks		No. of States
2.5 and under	45	5
4.5 " "	65	20
6.5 " "	85	21
8.5 " "	105	3
10.5 " "	125	2

Source: Social Security Board, *8th Annual Report 1943*, p. 97, Table 9, and *Social Security Yearbook 1942*, p. 162, Tables 121 and 122.

for maintaining even the minimum standard of living; the liberalization of benefits could easily create additional financial difficulties for those states whose reserves are relatively low. The pooling of state reserves into one fund would solve these financial problems. This is true, in the first instance, because such pooling would place the whole system on a safer foundation through the spreading of risk, and in the final analysis because in a national system the federal government would guarantee the financial integrity of the whole program.

An additional problem is created by the system of experience or merit rating practiced by many states. This consists of allowing employers with a better employment record a reduction from the standard payroll tax which is usually 2.7 per cent. Thus an inducement is offered to employers to stabilize their employment. To the extent that such stabilization is within the powers of individual employers, this is a worthy purpose. But merit rating is not the only financial incentive to employment stabilization. Moreover, in very large measure fluctuations in employment are entirely beyond the control of an employer. Employment fluctuations tend to be very large, for example, in the heavy-goods industries. Individual employers cannot control the national causes of employment.³⁰

³⁰ Sir William Beveridge argues against the principle of giving employers in industries with a steady employment record any benefit at all "All industries stand together . . . the contributions in one industry should not be increased on the grounds that it has an especially high rate of unemployment. The principle underlying unemployment insurance today is that industries cannot to any substantial extent control their own volume of unemployment and that no industry, accordingly, should contribute less to unemployment insurance because its normal rate of unemployment is below the average." (By permission of the Macmillan Co., *op. cit.*, p. 62.)

Experience rating is not necessarily a characteristic of our state-operated unemployment insurance as such, but the fact that it has been adopted by many states creates additional complications. Since there are considerable variations among the state laws, "competing employers in various States contribute at different rates even when their employment experience is identical. . . . The result of these discrepancies is to instill in the States fear of placing their employers at a competitive disadvantage, in comparison with employers elsewhere. This fear gives an incentive to distort employer experience-rating plans and to refrain from measures to improve benefit standards."²¹ Thus an unhealthy competition among the states to reduce payroll rates has developed. This difficulty would not be present in a national experience-rating system.

A unified unemployment insurance operated by the federal government would also be more economical, both for the collecting agencies and employers. The federal government already collects payroll taxes for old age and survivors insurance. The inclusion of unemployment data would hardly result in any appreciable increase in work. Employers doing business in more than one state would save much time and expense by being required to fill out one form only. Finally, as Mr. A. J. Altmeyer has said "A further advantage of a federal unemployment compensation program is that it could be much more readily adapted to meet emergency and changing conditions affecting our whole economy. Under such a system, action by Congress would be sufficient to effect changes which experience shows to be necessary. While under the existing federal-state system, general action to effect any changes must be taken by each individual state."²²

The opposition to outright federalization at the present moment is very strong, and a compromise which would take account of the federal form of government on the one hand and the needs of the present economic system on the other hand may therefore be necessary. Such an improved federal-state unemployment system should contain the following features. It should provide for the levying of a uniform tax from all states by the federal government. The yield of the combined federal and state unemployment taxes thus levied would then be

²¹ Social Security Board, *7th Annual Report*, p. 16

²² Arthur J. Altmeyer, "War and Postwar Problems," in *War and Postwar Social Security* (American Council on Public Affairs, Washington, 1943), p. 25.

shared by the federal government and the states, for instance in the ratio of one-third to two-thirds. The states could dispose of two-thirds of the total revenue immediately for their benefit programs, while one-third would flow into a federal equalization fund. The federal government should set up a schedule of uniform minimum benefits for all the states which would, however, be free to pay larger benefits if they themselves provide adequate financing. If the unemployment benefits (which should include also dependents' allowances) paid out by a state exceed the two-thirds of the tax yield which it obtains from the federal government, resort should be had to the reserves of the state which it has accumulated at the present time and afterwards to the federal equalization fund to supply the difference. In case the federal equalization fund should prove inadequate, this fund should receive a loan by the Treasury which would be paid back later from accumulated surpluses.³³

(3) *Health Insurance*.—No national program of economic security can be regarded as in any sense complete or effective without adequate provision for meeting the risks which arise from ill health. Fear of sickness and accident, causing loss of earnings, and dread of the costs of medical care are specters that haunt the great majority of the American people.

Every careful study of the economic experience of wage-earning families has revealed the inadequacy of individual savings to afford full protection against the costs of ill health. The incidence of disability is highest among the lower-income groups and it has been shown by surveys that the proportion of families receiving inadequate care is largest among those with small incomes. Among families on relief canvassed in the National Health Survey, acute illness was 47 per cent more prevalent than among families with incomes of \$3,000 or over. The average person in a relief family experienced three times as many days of disability annually as the average person in the upper-income group. Nonrelief families with incomes of less than \$1,000 experienced twice the rate of disability of families in the higher-income group. One family head of every 20 in the relief population was unable to work because of chronic disability, as contrasted with only one in 250 of the

³³ Cf. George F. Rohrlich, *Adequacy and Soliency in Unemployment Compensation, the Need for Federal Equalization*, Ph D. Thesis, Harvard, 1943.

heads of families with incomes of \$3,000 or over. Thirty per cent of cases of serious disabling illnesses among relief families received no physician's care; in families just above the relief level, 28 per cent were without doctor's care.³⁴

Even among the middle classes, the costs of medical care often prove too large for the average family budget. This follows from the fact that the sickness falls more heavily on some than on others. A study of family expenditures made in the thirties revealed that "Among Portland families, for example, about 7 per cent of those with incomes between \$750 and \$1,000 made almost one-third of the aggregate expenditures for medical care, and at the \$3,000 to \$3,500 level, less than 9 per cent of the families spent about one-third of the aggregate medical care expenditures of the group."³⁵

The risks of economic security arising out of ill health are of three kinds: (a) loss of earnings; (b) costs of medical care; (c) loss of efficiency and the undermining of earning capacity.

The provision for the first of these risks has already been discussed in the earlier sections. Insured persons should be entitled to old-age and survivors benefits in case of permanent disability, or to regular unemployment benefits in case of sickness or temporary disability.

The cost of care in sickness, however, generally exceeds wage loss due to temporary disability. Protection against this hazard, whose incidence is irregular and unpredictable and therefore defies budgeting by the individual, requires the spreading of the burden of sickness costs among a wide group of the population. Health insurance should be made an integral part of the social-insurance program. Finally, the risks involved in the loss of efficiency and the sapping of earning capacity through the devastation of illness and disease can be met only by advances in medicine and by adequate provisions for the prevention of ill health through organized public-health work. This aspect of the problem will be discussed at a later point.

Provisions for health insurance are set forth in S. 1161, introduced by Senators Wagner and Murray in the First Session of the 78th Congress, as part of a unified national social-insurance system. Under the

³⁴ U. S. Public Health Service, *The National Health Survey 1935-36*.

³⁵ U. S. Bureau of Labor Statistics, *Study of Consumer Purchases, Family Expenditures in Selected Cities, 1935-36*, Vol. 5, "Medical Care," Bulletin 648 (Washington, 1940), p. 44, footnote.

provisions of this bill there would be set up a federal system of medical and hospital insurance for all persons covered under old-age and survivors insurance and for their dependents. The number of persons so covered would be considerably enlarged as well. Each insured worker and his dependent wife and children would be entitled to the services of a physician who is a general practitioner, and, on the doctor's advice, to specialists, consultants, and laboratory services (including X-ray, appliances, eyeglasses, etc.) and necessary hospital care. Freedom of medical practice is carefully safeguarded. Each insured person is entitled to choose his own doctor from among all physicians in the community who have voluntarily agreed to enter the insurance service. Each doctor is free to participate in or stay out of the insurance system. Those doctors who participate are free to accept or reject patients who may wish to select them as their family doctor, and the participating doctors are likewise free to choose the method of payment from the insurance fund, subject to regulations prescribed by the Surgeon General. Doctors practicing as specialists would be entitled to special rates of payment if they meet professional standards for specialists. Thus, existing arrangements for choosing a doctor and obtaining medical, laboratory, or hospital care would not be disturbed except that payment would be out of the insurance system. Three per cent of wages and salaries, collected through the unified contributions under the entire social-insurance system, would be set aside in a special account to meet these insurance costs. The bill contains various provisions to assure that medical benefits would be the highest quality that could be made generally available, would promote personal relations between doctor and patient, would emphasize prevention of disease, and would be adapted to the needs and practices of the community in both rural and urban areas.

Hospital care is limited to 30 days per year with a possible maximum of 90 days if experience proves that the insurance fund can afford it. All qualified hospitals are eligible to participate, and all illnesses are covered for hospital care except tuberculosis or mental disease. The insurance system would assure all essential hospital services. The cash benefit or the rate of payment to hospitals would be not less than \$3 nor more than \$6 per day up to 30 days in a benefit year.

The insured medical care covers all necessary service; limitations may be fixed later by the Surgeon General and the Social Security

Board if this should prove necessary. The medical and hospital care program would not include medicines outside the hospital, dental care, home nursing, private hospital rooms, and certain other services. This leaves a wide field for continued operation and development of voluntary hospital and medical service plans to supplement the minimum insurance benefits. No medical or hospital services are made available with respect to any injury, disease, or disability for which these services can be obtained under a workmen's compensation plan of the United States or any state.

The Surgeon General is authorized to negotiate co-operative working arrangements with appropriate agencies of the United States or any state or political subdivision, and with private agencies, institutions, groups, or individuals, to utilize their services and facilities on payment of fair and reasonable compensation.

The Surgeon General is authorized and directed, with the advice of the Medical and Hospital Advisory Council, to administer grants-in-aid to nonprofit institutions and agencies engaging in research or in undergraduate or postgraduate professional education. Such grants would be made for projects showing promise of making valuable contribution to the education and training of persons in furnishing medical and hospital, disability, and related benefits, or of making valuable contribution to human knowledge with respect to the cause, prevention, or methods of diagnosis or treatment of disease or disability. The maximum sum available each year for such grants-in-aid would be 1 per cent of the total expended for all benefits from the social-insurance trust funds exclusive of unemployment-insurance benefits, or 2 per cent of the amount expended for medical care and hospitalization benefit, whichever is lower.

PUBLIC ASSISTANCE

However all inclusive the social-insurance system may be made, there will always be a place for public assistance for needy persons who, for one reason or another, cannot qualify for insurance compensation, or whose benefits are grossly inadequate. This will be particularly so in the early years of the insurance system.

Public aid is usually offered either in the form of a money payment or as a direct service. In the first category we find payments to the aged, the blind, dependent children, and general relief. On the other

hand, assistance for maternal and child health, medical care and hospitalization in general, and vocational rehabilitation are offered, in the main, in the form of direct services. Either type of public aid usually involves a means test and is given only to the needy.

At present, the federal government provides 50 per cent of the cost of cash assistance (up to certain maximum benefits) to three groups of the needy—the aged, the blind, and dependent children.³⁶ In the fiscal year 1941-42, the federal government provided 49.2 per cent of the cost of old-age assistance, 41.2 per cent of the cost of aid to dependent children, and 47.3 per cent of the cost of aid to the blind.³⁷ But no federal help is provided for general relief.

Variations in payments among the states are due to three sets of conditions. First, there is the great disparity in per capita income among the states. Second, federal grants for special assistances (old-age, dependent children, and the blind) being given on a 50-50 matching basis (up to certain limits) are higher for recipients in the richer states since they are able to avail themselves of the maximum federal contribution. Table 37 shows the magnitude of federal grants per recipient of special assistance for five states with the lowest and five states with the highest per capita income.

Finally, there has been a tendency among the poorer states to utilize as much as possible those forms of public aid which had the highest percentage of federal participation, such as WPA, NYA, and old age assistance, and to neglect the general relief category for which no federal aid was provided. This is demonstrated in Table 38 on page 169. As a result of this distortion, additional hardship was often imposed on persons who, for one reason or another, were not employed on public projects and were in need of relief.

The complete absence of federal participation in the cost of general relief (since 1935) and the large outlays needed to provide both special assistance and general relief by the states and localities have compelled the state and local governments to limit public aid to their own residents and to impose rather long residence requirements for newcomers, in some states up to five years. As a result, many persons may be totally unable to qualify for relief or other types of assistance. State and local

³⁶ Special federal grants are given to the states also for maternal and child welfare, vocational rehabilitation and public-health work.

³⁷ Social Security Board, *7th Annual Report*, p. 80.

TABLE 37. Amount of Federal Grants Per Recipient (on a Monthly Basis) of Special Types of Public Assistance for Selected States in June 1942 *

Five States with Lowest Per Capita Income	Per Capita Income 1940 †	Old Age Assistance	Aid to Dependent Children (per family)	Aid to the Blind
Mississippi	\$220	\$4.42	\$10.07	\$5.33
Arkansas	247	4.03	7.16	4.82
Alabama	268	4.54	7.79	4.83
South Carolina	287	4.98	7.59	4.56
Georgia	313	4.21	11.31	5.79
Five States (including the District of Co- lumbia) with High- est Per Capita Income)				
Connecticut	855	14.93	19.64	14.89
New York	855	12.13	15.11	13.43
New Jersey	886	10.78	14.86	12.04
Delaware	940	6.15	16.32	—
District of Columbia	1,063	12.76	17.04	16.83

* Social Security Board, *7th Annual Report*, pp. 80-81, Table 11. The table was computed by multiplying the average payments in June 1942 by the percentage of the payments borne by the federal government in the fiscal year 1941-42.

† *Survey of Current Business*, Vol. 22 (July 1942), p. 22, Table 4.

residence requirements should be substantially reduced, say to a period of six months, or entirely abolished. If some residence requirements were retained, persons still disqualified should get direct assistance from the federal government.

There is general agreement among those who have studied the problem that the present method of distributing federal grants for public assistance is not satisfactory. Two major improvements are called for: (a) the substitution of a single general-welfare grant, to cover all public-assistance payments in lieu of the present special categories; and (b) the distribution of federal aid on a variable basis (taking account of relative need and financial ability) instead of the present 50-50 matching basis.

There is little rationale in the maintenance of separate accounts for each category of needy persons. Such differential treatment, as we have

TABLE 38. Percentage Distribution of State and Local Disbursements for Public Works and Public Aid
Fiscal Year 1939, by Regions*

Regions	Per Capita Income Payments † (calendar year 1939) (dollars)	Total (per cent)	WPA (per cent)	NYA (per cent)	Unemployment Compensation & Employment Service (per cent)	Special Assistance (per cent)	General Relief (per cent)
Continental United States	540.6	100.0	28.6	0.6	26.0	17.4	27.4
Northeast ‡	706.8	100.0	20.5	0.3	29.9	12.2	37.1
Far West §	606.0	100.0	22.2	0.4	25.1	25.7	26.6
Middle States	565.1	100.0	31.1	0.5	23.1	18.9	26.4
Northwest ¶	429.4	100.0	43.3	1.3	12.0	30.1	13.3
Southwest **	385.7	100.0	41.6	1.5	23.6	28.7	4.6
Southeast ††	298.8	100.0	52.6	1.7	26.5	15.4	3.8

* *Security, Work, and Relief Policies*, National Resources Planning Board (Washington, 1942), p. 307, Table 70.

† *Survey of Current Business*, Vol. 22 (July 1942), pp. 23-26, and *Statistical Abstract of the United States, 1941*, p. 10.

‡ Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont, and West Virginia

§ California, Nevada, Oregon, and Washington

|| Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, Ohio, and Wisconsin

¶ Colorado, Idaho, Kansas, Montana, Nebraska, North Dakota, South Dakota, Utah, and Wyoming.

** Arizona, New Mexico, Oklahoma, and Texas.

†† Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, and Virginia.

already seen, leads to distorted state and local welfare budgets. If present inducements to obtain a maximum of federal aid by favoring special categories of needy individuals were removed, the state welfare agencies would be in a position to develop rational and well-balanced assistance programs. This is especially important because of the differing composition of the public-aid population in the various states.

A number of methods for distributing federal public-assistance grants to states on a variable basis have been suggested. Mr. D. S. Gerig, Jr., after a thorough discussion of the subject, recommends what he calls the "ratio to national average" plan. According to it, "the percentage of federal participation for each State would bear the same ratio to the percentage of State participation as the national per capita income bears to the per capita income of the State"³⁸ Another method was suggested by Senator Connally in a bill to provide a larger federal contribution for old-age assistance.³⁹ The federal government would contribute two-thirds of the first \$15 per recipient and one-half of any excess over \$15.

The first of these plans offers a number of advantages and has, as a matter of fact, been incorporated into several social-security bills recently introduced in Congress. Its major advantages are that it can be geared more readily to the distribution of a single public-assistance grant and that it would permit increased grants to the poorer states without at the same time involving greatly increased grants to the richer states. Since the federal government has already committed itself to matching state public-assistance payments up to 50 per cent of the cost (within certain limits) it would be feasible to continue this arrangement in the case of the richer states and to increase the federal share of the public-assistance costs in the case of the poorer states, possibly up to 75 per cent of the total expended within such states. Under this arrangement, the states whose per capita income (preferably, the average per capita income for the three most recent consecutive years) is equal to or greater than the national per capita income would receive grants covering 50 per cent of their welfare costs. The states whose per capita income is less than the per capita income of the

³⁸ Daniel S. Gerig, Jr., "Formulas for Variable Federal Grants-in Aid," *Social Security Bulletin*, Vol. 3 (June 1940), pp. 3-14.

³⁹ S. 3030, introduced in the Senate of the United States January 4, 1940 by Senator Connally, 76th Congress, 3rd Session.

entire nation would receive grants covering 50 to 75 per cent of their public-assistance costs, depending on the ratio of state per capita income to the national average per capita income. Thus, if the national per capita income was \$500, and the per capita income of a certain state was \$250, the federal percentage of participation for that state would be 66⅔ and the state percentage would be 33⅓.

Since the major purpose of the variable feature of the federal welfare grants would be to encourage the adequate support of needy individuals throughout the country, the intrastate arrangements for financing public assistance cannot be disregarded. It is important to note, at the same time, that the data available reveal that per capita income within a state is a far more important determinant of the level of public-assistance payments than is the relative proportions of the cost contributed by the state and local governments. There can be no doubt that, in order to provide a minimum level of assistance payments everywhere, the first consideration is the distribution of the federal welfare grants among the states on an equalization basis. Nevertheless, the intrastate fiscal arrangements exert a substantial influence over the adequacy with which the various states meet the public-aid problem.

An outstanding feature of the intrastate financing of public aid is the marked variations in the relative shares of state and local funds for the different programs. For the fiscal year 1940, for example, the percentage distribution, by source of funds, of net disbursements (excluding cost of administration) was as follows:

TABLE 39. Expenditures for Public Assistance by Source of Funds
Fiscal Year 1940

Program	Federal Funds (per cent)	State Funds (per cent)	Local Funds (per cent)
Old-age assistance	49.0	41.1	9.9
Aid to dependent children	34.0	42.6	23.4
Aid to the blind	45.3	35.2	19.5
General relief	0.	59.2	40.8

Source *Social Security Bulletin*, Vol. 4 (February 1941), p. 56.

Whereas the localities in the country as a whole carried only 9.9 per cent of the expenditures for old-age assistance, they were required to bear 40.8 per cent of the cost of general relief. Moreover, they were required to bear a larger share of the costs of aid to dependent chil-

dren than of aid to the blind. It is significant that the differing extent of state participation has influenced the adequacy of the aid made available for these different programs. Thus, the payments made to recipients of old-age assistance and aid to the blind were in general higher than those available to recipients of aid to dependent children and of general relief. Moreover, general relief, which is the least adequate of all programs both in terms of availability of aid and level of assistance, is also the program which relies most largely upon local financing.⁴⁰

Provisions for the distribution of the costs of the various public-assistance programs between state and local governments vary greatly among the states, as shown in Table 40.

TABLE 40 Distribution of Public Assistance Costs between States and Localities (Excluding the Federal Share), July 1, 1940 *

	(number of states)			
	Old-age Assistance	Aid to Dependent Children	Aid to the Blind	General Relief
Complete state support	26	15	25	3
State local sharing	22	25	16	33
Complete local support	—	—	—	12

Source: National Resources Planning Board, *Security, Work, and Relief Policies*, 1942, pp. 311-312.

* Excluding District of Columbia, Alaska, and Hawaii.

Where the local unit is left with a burden disproportionate to its resources, the consequence is all too often that the function is badly performed. Either public assistance is available only to a small number of people, or average grants are low. There is great inequality among local areas in any one state in the financial burdens of public assistance, which generally results in great intrastate inequalities in the levels of assistance provided. Thus the range in county average payments to recipients of old-age assistance is very great. Some of these ranges in county payments, as of December, 1937, are set forth in Table 41.

Variations in the level of relief payments are even more striking. New York ranked second among the states in terms of per capita income in 1939. In the fiscal year ending June 30, 1939, the localities pro-

⁴⁰ *Security, Work, and Relief Policies*, pp. 320-321.

TABLE 41. Range in Old-age Assistance Payments Among Counties in Selected States, December 1937

State	Number of Counties in State	Range in County Average Payments	Average Payment for the State
Louisiana	64	\$ 5 88-\$14 90	\$ 9 92
North Carolina	100	5.30- 16 00	9 28
Alabama	67	5 46- 18 22	11 06
Indiana	92	6 43- 24.48	16.00
New York	57	13 71- 34 70	21.49 *
Kansas	105	10.35- 25 32	18 52
South Carolina	46	6.70- 14 15	11.04
Florida	67	9 86- 20 58	15 92
North Dakota	53	10.85- 20.53	16 79
Idaho	46	10.13- 27 81	21 68

Source: Social Security Board, Bureau of Research and Statistics, Report No. 1, *Tabular Summary of Statistics of Public Assistance* (Washington, 1938), pp. 13-52, Table 12.

* Not including payments in New York City.

vided approximately 60 per cent of expenditures for general relief. The actual expenditures per case for general relief varied in April, 1940, from \$14.61 per family in the comparatively poor county of Schoharie to \$48.62 in the relatively wealthy city of Mount Vernon.⁴¹ Although differences in local acceptance of responsibility play a role, the data available reveal that by far the most important factor is the relative tax resources among the various localities. It is significant that the ranges in public-assistance payments are less marked in those states which give substantial assistance to their localities on a variable basis. Another factor which seems to have influenced the extent to which equalization has been assured is the size of the local welfare unit. Where local units are small and numerous, sharp differences in wealth are greater, and efficient local administration and adequate state supervision are more difficult to secure.⁴²

If adequate support of the needy is to be provided throughout the country, it would be necessary to undertake state equalization programs as well as federal variable grants. Thought should be given to the possibility of making the welfare grants contingent on certain

⁴¹ State of New York Department of Social Welfare, *Social Statistics*, April-May-June 1940, p. 26.

⁴² *Ibid.*, pp. 310-321.

approved provisions within the state programs. These provisions should include (1) a minimum percentage of state support of the non-federal share of the costs, (2) the development over time of local welfare units of sufficient population and financial resources to carry out the function effectively, and (3) the distribution by the state of the federal funds (at least up to the percentage of the local participation in financing the costs) on a variable basis, with due consideration for relative need and financial resources. Only if such provisions are included in state welfare programs can we hope to achieve a satisfactory minimum throughout the entire nation.

PUBLIC-HEALTH SERVICES AND FACILITIES

A comprehensive and integrated system of social security involves not only social-insurance and public-assistance programs but also the provision of certain important public services and facilities. The question arises as to which of the manifold services rendered by governmental units should be included in the social-security program. No unequivocal answer can be given. Account must, of course, be taken of traditional concepts and arrangements. Possibly the most fruitful criteria of the services to be included in the social-security program are those which (a) are directly related to the insurance and public-assistance phases of the program, (b) involve a direct national as well as state and local interest, and (c) require joint financing.

Following these criteria, the services which might well be considered within the sphere of social security are public health, medical care, vocational rehabilitation, and nutrition. The lines cannot be sharply drawn, particularly since the nature of the social-security program may be expected to change over time. It is proposed, however, that for the immediate future it would be highly desirable for the federal government to underwrite a national minimum for the above-mentioned services as part of an integrated, nation-wide social-security program.

At the present time, federal funds are provided, under the Social Security Act and the Venereal Diseases Control Act, for several phases of public-health services. In the fiscal year 1941, for example, federal aid to the states for public health involved the following: \$10.3 million for general public-health work, \$5 million for crippled children, \$3.7 million for maternal and child health, and \$5.5 million for venereal-

disease control.⁴³ In the distribution of parts of these grants consideration is given to relative need and financial resources among the states. Nevertheless, a number of careful studies of public health, made under both private and public auspices, have revealed not only that health services are quite generally inadequate, but that marked differences exist between the mortality and morbidity records of the different states and localities.⁴⁴ It has also been established that the adequacy of the health services provided in various communities depends chiefly on the relative economic resources. The greatest deficiencies in health and hospital facilities as well as the most serious health problems are found, on the whole, in the poorest sections of the country. Moreover, studies of the Bureau of Home Economics indicate that a large part of the population have diets that are definitely deficient in important nutritive elements.

It is encouraging that state and local health services have improved greatly in recent years. The number of full-time public-health departments increased from 540 to 976 in the seven years following the passage of the Social Security Act. Also, largely through federal stimulation, increasing attention has been focused on problems associated with maternity and childhood, and on venereal-disease control. Joint governmental effort in developing public-health and medical-care services is making progress; but enlargement in the scope of such services is needed.

A firm basis of support for health services and facilities requires the underwriting of a national minimum by the federal government. This can best be accomplished through federal general-purpose public-health grants to the states on an equalization basis. Such grants, covering a certain percentage of the cost of integrated state public-health and medical-care programs, would offer a number of important advantages as compared with the present special-purpose health grants. They would encourage balanced programs at the state and local level and

⁴³ U. S. Bureau of the Census, *Federal and State Aid 1941*, p. 18.

⁴⁴ Committee on Economic Security, "The Extension of Public Health Services," *Social Security in America* (Social Security Board, 1937), pp. 315-342; Interdepartmental Committee to Co-ordinate Health and Welfare Activities, *The Nation's Health* (Washington, 1939); Hearings, Sen. Comm. on Education and Labor on S. 1620, 76th Congress, 1st Session, *To Establish a National Health Program* (Washington, 1939); American Medical Association, Bureau of Med. Econ., *Factual Data on Medical Economics* (New York, 1939).

would give an adequate scope for adjustment to local conditions. They would permit the integration of the health services with the social-insurance and public-assistance programs. They would offer a larger scope for equalization.

A comprehensive state program designed to achieve, as a major objective, the conservation and enhancement of the health and well-being of the people can be expected to include, in broad outline, the following elements:

1. Development of public-health services, under full-time, competent health departments, including disease control (with facilities for institutional care), supervision of sanitation, diagnostic aid (with laboratory services), collection and analysis of vital statistics, and medical and scientific research.

2. Promotion of maternal, infant, and other child-health services, including public-health nursing services, prenatal clinics, child-health conferences, preschool and school medical examinations accompanied by adequate follow-up work, hospital and clinical care of the sick and care at maternity, services for the physical restoration of crippled children, and mental hygiene.

3. Protection of factory and farm workers against health hazards (occupational accidents and diseases), including provision of industrial-hygiene units and inspection staffs, research into causes and cures of occupational diseases, and studies of means of eliminating accidents and assuring working conditions that are conducive to good health.

4. Provisions for medical care and hospitalization, including adequate bed facilities in general and allied special hospitals; adequate hospital, health-center, and clinical facilities; adequate and qualified medical personnel and training facilities (doctors, dentists, nurses, and laboratory and technical workers); provisions for medical care of the needy.

5. Vocational rehabilitation, including all services necessary to render a disabled individual fit to engage in a remunerative occupation, including medical examination and care, physical restoration and repair, physical and occupational therapy, training, assistance in securing employment, and other appropriate services.

6. Promotion of proper nutrition, including the use of techniques such as free school lunches, penny milk, stamp plan; support of public and private agencies engaged in the dissemination of sound nutritional

practices and principles among consumers and producers (including research, demonstration work in schools, factories, and farming areas, and development of improved facilities for quick freezing, dehydration, etc.).

7. Co-ordination, stimulation, and supervision of the health and medical agencies and facilities in each community within the state, and the underwriting of a minimum effective health program within all local areas.

In recent years, private and public expenditures for health and medical care services in the United States have been between \$3 billion and \$3.5 billion per annum. Tax-supported public-health and medical services involved annual expenditures of roughly \$550 million to \$650 million. About 4-5 per cent of the cost was met by philanthropy and industry, and the rest, about 75-80 per cent of the nation's health bill, has fallen upon families and individuals. The Bureau of Labor Statistics approximated, from a study of 14,469 families of wage earners and clerical workers, that the average expenditures for medical care amount to 3.9 per cent of total family outlays.⁴⁵ The percentage was fairly constant in the various income brackets, ranging from a low of 3.4 per cent to a high of 4.2 per cent.

An extensive health-insurance program, covering hospitalization and medical care of the greater part of the population, would absorb not only most of the individual health costs but a substantial share of the costs now covered by tax-supported public-health and medical services as well. These two phases of the social-security program are closely interwoven. The greater the coverage of the insurance system, the less will be the costs of the public medical-care services. At the same time, however, in order to effectuate and safeguard a national health-insurance system, there must be adequate and somewhat similar health, medical-care, and hospitalization facilities throughout the nation. Provisions for hospitalization, serums, X-ray treatments, etc., guaranteed

⁴⁵ F. M. Williams and A. C. Hanson, *Money Disbursements of Wage Earners and Clerical Workers, 1934-36*, Summary Volume, U. S. Bureau of Labor Statistics, Bulletin No. 638 (Washington, 1941), Ch. IX, p. 151. This estimate of \$16 average medical care expenditure per person is very close to that of the Technical Committee on Medical Care of the Interdepartmental Committee to Co-ordinate Health and Welfare Activities. On the basis of a study of 9,000 families, the Committee estimated an average medical-care expenditure (exclusive of dentistry and drugs) of \$16.86 per person.

under an insurance program, are meaningless unless the necessary facilities are available in the community of each insured person. A program for underwriting minimum health services and facilities throughout the country is obviously a direct corollary of a national health insurance system. On this count alone, a substantial federal health grant to the states on an equalization basis is called for—a grant which should be contingent on the development of integrated state programs aimed at providing adequate health and medical-care services and facilities within all communities.

In the last few years, governmental health activities have involved outlays—in round numbers—of about \$150 million for disease control and general health services, \$350 million to \$380 million for care in hospitals, \$50 million for care in homes, and \$60 million to \$90 million for hospital construction. It is likely that most of the medical-care costs would be absorbed into the insurance program. At the same time, however, there is need for expansion of public-health activities—especially in preventive health services, nutrition, vocational rehabilitation, and child and maternal care—and a substantial expansion of hospital construction. Assuming the establishment of an extensive national health insurance system, it is estimated that a rounded program of public-health activities will involve governmental current expenditures of approximately \$1.50 per capita, or \$200 million to \$225 million annually. The costs of vocational rehabilitation in the postwar period might well push the public-health outlays for a decade after the war to the upper end of the range suggested.

In the period of 1920-42, \$2.7 billion were spent on the construction of hospitals, both public and private, an average outlay of \$118 million per year. The construction expenditures ranged from a high of \$219 million in 1928 to a low of \$41 million in 1935. Public expenditures for hospital construction from 1920 through 1929 were a little less than one half of the total spent, but from 1930 through 1939 they constituted about two-thirds of the total. By far the largest share of hospital-construction costs will have to be financed by public funds in the decade after the war.

To bring the hospital facilities of the country up to generally accepted standards of adequacy, a large hospital-construction program will have to be undertaken. It is assumed that the need for the construction of hospitals and health centers will be determined by (1)

new needs arising from the estimated population growth and a consequent demand upon hospital facilities for additional service; (2) *current replacement* made necessary by current obsolescence and depreciation of existing hospitals; and (3) *accumulated deficiencies* caused by failure in the past to keep up with population growth, the wearing out of facilities, and the advances in the standards for hospital facilities. It is estimated, on the basis of available statistics, that to meet these needs within a decade after the war, say between 1945 and 1954, some \$2.8 billion to \$3.2 billion (at 1941 prices) will have to be spent on the construction of hospitals and health centers, or some \$300 million a year—with possibly \$270 million a year from public funds.

Federal grants will be needed to meet a substantial share of the public-health and hospital-construction costs. The central purpose of the federal health grants should be to furnish an adequate basis of support for comprehensive state and local health programs.

Federal aid should be devised to bring about (a) a minimum effective health program in every community of the country, (b) progressively higher administrative standards, (c) a reasonable effort on the part of the states and localities to support this important service, (d) integration of the public health and medical-care programs with the social-insurance and public-assistance programs, and (e) a flexible adjustment in the meeting of special health problems.

To achieve these objectives, it is proposed that federal aid totaling \$225 million to \$250 million will be needed, or about 40-50 per cent of the required outlays for public health services and for hospital construction. Such aid might take the form of three grants: (1) a general-purpose health grant, on an equalization basis, to underwrite the state health programs, (2) a grant for hospital construction, and (3) a grant distributed by the federal health administrator on a flexible basis to meet special health problems.

The general purpose grant should be distributed on the basis of a statutory formula to finance a given share of the costs of carrying out approved state health programs. The allotments to the states should vary inversely with per capita income (determined on a three year moving average) ranging from, say, one third to two thirds of total current state outlays. Provisions should be made in the state programs for distribution of a given share of the federal funds to localities on an approved equalization basis.

A separate grant for construction of hospitals and health centers would permit more flexible control in the encouragement of effective local health-administration units, a balanced distribution of hospital services as between rural and urban areas, and integration with other governmental construction programs. It is assumed that the federal administrator will be granted powers of approval over individual projects so as to safeguard standards of adequacy (in keeping with the requirements of the national health-insurance program) and to foster the developments of effective local administrative units. The federal share in financing construction costs should be equal to the share provided under the general-purpose health grant so as to encourage balanced programs at the state and local levels. There should be no inducement for the nonfederal units to expand either construction or current outlays—the one at the expense of the other—in order to maximize the amount of federal funds received.

Finally, a federal-aid fund should be provided to meet special health problems. Such a fund is necessary in order to provide a necessary element of flexibility in safeguarding the health of the nation. It will suffice to mention a few items which require flexible treatment: epidemics, special costs involved in certain areas in order to control interstate transmission of disease, unusually high costs in the control of certain occupational diseases, and special child-care problems. Flexibility is desirable also in speeding up the provision of urgently needed health facilities in areas which now lack such minimum facilities. On a tentative basis, it is suggested that the federal administrator be provided annually with a fund for this purpose equal to 10 per cent of the total distributed under the general-purpose grant for the previous year.

PART THREE

The Over-All Budget, Full Employment, and Economic Stability

Chapter Nine

PUBLIC EXPENDITURES, INCOME CREATION, AND COSTS

IN PART II we have discussed ways and means of raising the national income, increasing the productivity of the people, developing the national resources, both material and human, and strengthening the fiscal position of local governments by regional resource development and by the development of urban communities and the redevelopment of slum and blighted areas. We have, moreover, discussed the role of the federal government in underwriting a minimum program of social services, involving: variable grants-in aid to education, relief and other welfare expenditures, and to public-health measures; as well as a broad program of social security partly financed from the federal budget.

Such a program obviously cannot be carried through without a very large federal budget. And this must raise the question in the mind of the reader: Will not such large expenditures involve taxes so burdensome that in fact the aims and purposes of the expenditures will prove to be self-defeating? Will not such a budget weigh so heavily upon business as to curtail expansion and restrict employment opportunities?

Many readers will doubtless instinctively conclude that these unfortunate consequences must inevitably follow from the policies that we have advocated. This conclusion springs quite naturally from traditional thinking about public expenditures and taxation. In the tradi-

tional view attention was too often fixed upon the tax burden, while the expansionist effect of governmental expenditures was largely forgotten.

In the rapidly growing and rapidly expanding economy of the nineteenth century, little attention needed to be paid to the depression phases. Accordingly, the fiscal tenets applicable to the conditions of boom and expansion were usually regarded as rules that could properly be followed consistently from year to year without interruption and without adjustment to the changing phases of the cycle. But when the emphasis shifted to the problem of full utilization of the vast productive resources which modern technical development had provided, it became evident that the traditional policies could not continuously be applied, irrespective of economic conditions, without great damage to the economy. This called for a reorientation of thinking. It required the pursuit of a new type of fiscal policy designed (a) to act as a balance wheel offsetting fluctuations in the private sector of the economy, and (b) to promote and maintain full employment and rising living standards.

It should be stressed that modern fiscal theory has not made the mistake, which can be charged against the traditional "sound finance" policy, of assuming that identical fiscal policies can appropriately be applied to all phases of the cycle. Under the old traditional theory of sound finance, the dogma was vigorously maintained that public expenditures must under all conditions be cut rigorously to the bone and that a balanced budget year in and year out was always correct fiscal procedure.

Modern theory holds, on the contrary, that it is sound fiscal policy to control public expenditures, taxation, and borrowing so as to promote economic stability at continuously high levels of business activity and full employment. A sound fiscal program, according to this view, involves curtailment and restraint in periods of extreme boom in order to prevent inflation, while in periods of depression it involves an increase in public expenditures in order to prevent deflation and mass unemployment. Modern fiscal theory holds that it would be quite irresponsible to cut expenditures, increase taxes, and reduce the public debt in a period when the effect of such a policy would be to cause a drastic fall in the national income. Equally it would be finan-

cially irresponsible to raise expenditures, lower taxes, and increase the public debt when there is a tendency toward an inflationary boom.

In order to achieve continuously high levels of income and employment, it will be necessary (once the stimulating effects of the war have spent their force) to pursue a bold and vigorous fiscal policy. In our own country, as in most advanced countries, there is a wide field for useful and productive public expenditures without encroaching upon the accepted traditional sphere of private enterprise. These include public-investment aspects of urban redevelopment, slum clearance and low-cost housing, transportation facilities, river-valley development, flood control, soil conservation, reforestation, rural electrification, international investment projects, and finally a public-welfare program including equal educational opportunities, child welfare, public health, nutrition, and an extension of our system of social insurance. Public resource development projects not only raise the productivity and standard of living of the areas in which they are made, but also open up private investment outlets. Moreover, social-welfare expenditures act like an irrigation system, distributing purchasing power widely over the whole country, thereby raising the level of consumption expenditures and business activity.

In order to pursue a rational fiscal policy, any administration in power must determine how far we can go with public expenditures in view of the limitation of productive resources without producing an inflation, and, on the other side, how far we *must* go in order to sustain a level of effective demand adequate to provide full employment. It should be stressed that fiscal policy alone is not adequate; appropriate wage and price policies are equally important. A sound fiscal program requires that close attention be paid to the kind of expenditures that are made, choosing those that are most useful in raising the standard of living and increasing the productivity of our natural and human resources. It requires also that particular attention be paid to the kinds of taxes employed and the degree to which the budget can wisely be covered by taxation. If borrowing is employed, it requires, moreover, close attention to the appropriate source from which funds are derived. All of these will vary according to economic circumstances and according to the various phases of the business cycle.

There is one aspect of popular thinking with respect to public ex-

penditures which was never accepted by modern scientific writers—even those adhering to the traditional “sound finance” school. The popular view is that government expenditures and activities are entirely sustained and supported out of income derived from private business. This is quite wrong, as a little economic analysis will reveal. The public expenditures made in operating a public school are no less income creating and productive than a private business—say, a cosmetics factory. Indeed, the public school is productive, not only in the sense that it supplies a want-satisfying service (as does also the cosmetics factory) but also in the respect that it increases the efficiency and productivity of the future labor force of the nation.

Economic activities, whether governmental or private, involve two operations with respect to their impact in the flow of income which must be entered on opposite sides of the ledger; and quite erroneous conclusions follow by looking at one side and closing one's eyes to the other side. With respect to the cosmetics factory, the erroneous argument might be advanced that it is a burden on the community since the sale of its products drains off a part of the money income flow from the community; that the cosmetics factory is dependent upon all other businesses since they are the ones that create the income stream and the purchasing power enabling the factory owner to find a market for his product. This analysis would, however, be quite unfair to the factory owner since, in fact, at the same time that he taps a stream of purchasing power in selling his product, on the other side he turns an equivalent amount of purchasing power right back into the income stream through the expenditures involved in operating the factory. He therefore sustains other businesses just as much as they sustain him.

Precisely the same is true of government expenditures and activities. The government, in operating the school, taps a part of the income stream in the form of taxes, but it throws this right back into the income stream through the expenditures made in operating the school. It is not true that government is sustained and supported out of private business any more than that private business is supported and sustained out of government expenditures and activities.

No private business can sustain its sales volume unless the outlays of other businesses and the government continue to feed the income stream. Nor is private business as a whole self-sustaining. It was not self-sustaining when the national income fell from \$80 billion to \$40

billion in the early thirties, nor indeed in any other period of depression. The sales receipts of private business, no less than the tax receipts of government, depend upon the maintenance of a high national income. And the outlays of government can and do contribute to a sustained national income, no less than the outlays of private business. Indeed, when private-business outlays decline, the government alone is in a position to go forward and sustain the income through increased expenditures.¹

In discussing the productiveness of public or private investment, it is important to make a sharp distinction between (a) the creation of a flow of real income of goods or services and (b) the creation of improved instruments of production which increases the efficiency of labor and results in a larger flow of real income with the existing labor than would otherwise be possible. The former is a utility-creating expenditure; the latter is an efficiency-creating expenditure. Investment which duplicates existing plants in accordance with the requirements of growth (as, for example, the erection of another radio factory) is of the former type. Investment in improved machinery is of the latter type.

The view that public investment is "unproductive," while private investment is productive, will not withstand careful analysis. Public investment, just as with private investment, may be merely utility creating or it may also be efficiency creating. The development of a public park, swimming pool, playground, or concert hall makes possible a flow of real income no less than the erection of a radio factory. Public investment in the national forest, by preventing soil erosion and floods, or the construction of school buildings, may contribute to raising the efficiency of labor no less than private investment in improved machinery. Public investment, like private investment, if wisely made will be utility creating, or both utility and efficiency creating.

A partial picture of the governmental contribution to our economic life can be obtained from an examination of the component parts of the national income. Table 42 presents the distribution of the national income by "industrial" source for the years 1929-42.

As this table reveals, the sector occupied by government is relatively

¹ Alvin H. Hansen, *Fiscal Policy and Business Cycles* (W. W. Norton and Co., New York, 1941), pp. 146-152.

TABLE 42 National Income and Its Distribution by Major Industrial Divisions, 1929-42
(in billions of dollars)

	Gov.	Agr.	Mining	Mfg.	Constr.	Transp. and Other Pub. Util.	Trade	Finance	Service	Misc.	Total
1929	64	68	19	209	35	95	11.9	10.1	83	4.0	833
1930	65	52	14	155	26	84	97	8.7	7.5	3.5	689
1931	66	36	8	105	18	71	78	7.0	6.3	3.0	545
1932	66	24	5	62	.9	55	56	5.3	47	2.4	40.0
1933	66	30	.6	84	.5	53	63	4.8	46	2.2	42.3
1934	77	35	1.0	108	.7	56	74	5.1	52	2.5	49.5
1935	80	50	1.0	128	9	60	82	5.7	56	27	557
1936	93	53	14	156	14	68	94	6.5	63	2.9	64.9
1937	91	61	17	180	18	73	104	69	69	32	71.5
1938	99	50	12	136	18	66	98	67	67	31	64.2
1939	100	52	14	170	19	73	110	68	70	32	70.8
1940	103	53	18	203	21	79	122	70	74	35	77.8
1941	115	73	21	276	35	93	144	77	80	42	95.6
1942	164	11.0	24	367	49	108	157	8.3	9.2	45	119.8

Source Survey of Current Business, March 1943, p. 22, Table 14.

small, but it is none the less important. The government contribution to the income stream, while marginal in amount, may make all the difference between full employment and several millions unemployed. Moreover, under modern conditions, many wants can be satisfied *only* by governmental action, and in other cases *more effectively* by governmental action. Roads, streets, sewerage disposal, reforestation, flood control, parks, schools, public health, hospitals, low-cost housing, social insurance, public playgrounds, and other recreational facilities—all these represent ways of enlarging our real income far beyond what it could be if these things were not undertaken by government.

The *cost* of government services, which troubles so many people, is no more a "burden" than the *cost* of farm output, or the output of any other area of private production. Both are a "drain" on income in the sense that the part of income spent on farm products or government services cannot be used for other purposes, but both kinds of expenditures yield utilities and satisfactions. Moreover, both forms of expenditures provide income for the producers—whether farmers or government servants—and those groups in turn provide markets for other producing groups. We do not think of agriculture as a "cost," in terms of a burden or loss, to our society. Farming makes contributions to the satisfaction of wants—to the total net product of the nation—and, in return, receives its share of the total heap of goods and services. The same consideration holds for government.² In a basic sense, a burden or loss arises only when there is inefficient use of resources in governmental activity, or when governmental expenditures are made for services and projects that are less useful than others that might have been produced.

There is, to be sure, the important difference that money paid to buy farm products is spent voluntarily, while the taxes contributed³ to pay for community services are determined in a country like the United States by democratic vote. From this fact alone, however, one cannot conclude that the one is necessarily inferior to the other.

The notion that we cannot find the means to finance useful and productive government activities is quite without foundation. Every cent expended, private and public, becomes income for members of

² *Ibid.*

³ Loan financing, where desirable on other grounds, has the advantage that no compulsion is applied to the person who furnishes funds to the government.

our own society. We can afford as high a standard of living as we are able to produce. We cannot afford to waste our resources of men and material, and we cannot afford to use them inefficiently. But above all, we cannot afford idleness. The idleness of the decade of the thirties was responsible for the loss of \$200 billion of income, judged by 1929 standards. We know now that this is an understatement. We know now that our national income could have grown from \$80 billion in 1929 to \$120 billion by 1940. By these standards we lost \$400 billion of income in the decade of the thirties. The public expenditures required to rebuild America, to provide needed social services, and to maintain full employment can be provided for out of the enormous income which the full utilization of our rich productive resources (material and human) makes possible. The costs of producing this income are merely payments to ourselves for the work done. There is not—there cannot be—any financing problem that is not manageable under a full-employment income. From a \$135 billion income we can raise large tax revenues and still retain for private expenditures far more than we had left in former years under a \$70 billion income with lower taxes. Taxes are merely one way of paying for social services and public-improvement projects that we need. But it is not necessary or desirable *under all circumstances* to finance all public expenditures from taxes. Whether taxes should equal, fall short of, or exceed expenditures must be decided according to economic conditions.⁴

The cost of social insurance requires special consideration. This is true because the benefits derived from the social-security program accrue in a peculiar manner to special groups of individuals. The benefit accruing to society as a whole from public education is quite evident and will be accepted by everyone without further argument. Not only does the public education benefit the particular child in question, but benefits quite clearly flow to the nation as a whole from an educated citizenry. Improvement and conservation of natural resources, the development and redevelopment of our urban communities, the building of roads, etc., bring benefits to the nation as a whole and, broadly speaking, do not particularly affect any special group. In the case of social security, however, the beneficiaries—the aged, the sick, the unemployed—in many cases can be separated out, more or less, from the

⁴ Alvin H. Hansen, *After the War—Full Employment*, National Resources Planning Board, Washington, revised February 1943, pp. 6-7.

rest of the community. Accordingly the cost of the social insurance deserves special treatment.

It is true that the analysis just made can be overstressed to the point of artificiality. To a considerable extent it is true that most people look forward to old age and anticipate now and then sickness or unemployment. Since everyone is liable to each of these contingencies, the whole population is interested in the benefits received, and broadly speaking most members of the community will be beneficiaries at some time or other. Nevertheless, to the degree it remains true that one can separate out the beneficiaries of social security from the whole community, there arises the special problem of the costs of social security to the nation as a whole. The problem essentially is: Do the benefits from social security flow only to the immediate beneficiaries or are there broad social and economic benefits to the whole community which justify spreading the cost in greater or less degree?

There can hardly be any doubt that a well-organized system of public-health services and health insurance benefits the community as a whole. Higher standards of health and physical well-being are no less important from the standpoint of economic efficiency and productivity than education. There are good grounds for believing that up to certain limits at any rate the outlays for medical and hospital services constitute a profitable investment for the community as a whole and, therefore, the cost might in some measure be broadly distributed.

With respect to unemployment and old-age insurance, the social justification for spreading a part of the cost to the community as a whole must rest largely on other grounds. To the extent that the *community benefits are here less evident than is the case of education or public health*, it could be argued that the cost should be defrayed entirely by payroll taxes, which affect directly or indirectly the individuals covered by the insurance program. It is now generally accepted that the benefits received by these individuals are ample to justify these costs.

It is generally accepted that when the costs are covered by payroll tax deductions the incidence of the cost falls mainly upon the workers. If the cost were financed by payroll taxes assessed against employers, the ultimate incidence of the tax is less clear. In general, it is believed that such payroll deductions are either shifted forward to consumers in the form of higher prices or shifted back to the wage earner in the

form of lower wages or at any rate lower increases in wage rates than would otherwise occur. There is also the possibility that other distributive shares—interest, rent, or profits—may be affected, but this is relatively improbable, particularly if a sufficiently long period has elapsed to permit adjustment. In a dynamic society no definitive answer can be given in exact and categorical terms. On the whole, it may be said that the payroll tax applied to employers is more likely to be shifted forward through higher prices in times of high business activity, and backward to wage earners in the form of lower wages when business is slack. There are likely to be considerable variations among different industries and even among individual firms. For the purpose of this discussion, an exact solution is not necessary. All employees are consumers no less than wage earners and indeed they constitute the great bulk of the consuming public. Whether the employer payroll tax is shifted forward to consumers or backward to employees, it remains true that the larger part is borne by the wage-earning group. In general, therefore, it may be concluded that payroll taxes, whether assessed against employers or employees, are mainly deductions from wages and salaries.

This analysis leads to the conclusion that unemployment and old-age insurance financed from payroll taxes amount essentially to a manner of spending individual income. It is not true, therefore, that a 10 per cent payroll tax, for example, places an impossible burden upon industry. Indeed, the expenditures involved are made, broadly speaking, for much the same categories of goods and services for which wage and salaried workers would have spent the additional income had there been no payroll deductions. This is true because the aged person and the unemployed who receive the benefits spend their money for food, clothing, and recreation in very much the same manner as the employed younger person would have spent the extra income had he not set it aside as payment for these contingencies. Some shifts in the character of demand do, of course, occur. The wants of the aged are considerably different from those of employed persons. But by and large, old-age and unemployment insurance merely amount to a redistribution over time of the expenditure of wages and salaries.⁶ Less

⁶ In the absence of any insurance system, some redistribution over time similar to that achieved through insurance is accomplished through charity, gifts, and the support of unemployed and the aged by relatives.

is spent in the working years, and more in periods of unemployment and in old age.

We need, however, to probe more thoroughly the problem of the costs of social security and the appropriate method of financing from the standpoint of the general community interest. As we have just explained, payroll taxes fall essentially on the wage and salaried class and, therefore, broadly speaking, essentially on low- and moderate-income groups. As such, payroll taxes are likely to cause the flow of consumption expenditures of the mass of the population to be smaller than would be true in the case of a progressive income tax. Payroll taxes are proportional to wages received up to a certain limit. They do not, therefore, correspond well to the taxpayer's ability to pay. They are in fact, like sales taxes, regressive in character. It is therefore extremely doubtful that heavy reliance upon payroll taxes can be regarded as sound fiscal policy for an advanced industrial country like the United States in which the threat of mass unemployment looms large. The social-security program can be financed at least in part by taxes which are more favorable to consumption, thereby promoting a higher level of employment.

A social-security program financed from payroll taxes is deflationary if benefits do not equal contributions; in other words if reserves are being accumulated. With respect to unemployment insurance, it may be expected that the benefits paid out in periods of depression will considerably exceed the deductions from payrolls. The net effect, in such periods, is therefore expansionary. In the case of old-age insurance, in the event that the system provided in the initial years for such heavy payroll deductions that they greatly exceeded the benefits paid out to the aged, resulting in the accumulation of a large reserve fund, then such an old-age-insurance system would be seriously deflationary.

To summarize briefly, in a social-security system in which the benefits paid out are currently below payroll deductions, and a large reserve fund is built up, the effect is deflationary. If income and outgo are in balance the effect is neutral. If, however, the program is partly financed from progressive income taxes on the community as a whole, the combined effect of the benefits paid out and the tax program may be expansionist since a social-security program so financed would tend to redistribute income in a manner that would promote a high-consumption economy. Thus a social-security program, properly

financed, may, through the distribution of purchasing power involved, promote full employment and a higher level of business activity.

The question whether social security really costs anything or not from the standpoint of the economy as a whole thus depends fundamentally upon what assumption is made with respect to underemployment or full employment. A society that typically operates at conditions of serious underemployment is likely to discover that the introduction of a social-security program financed in part by progressive taxation would raise the level of employment. In this sense the social-security program, far from costing the society anything in real terms, in fact helps to promote a higher real income. It is now generally recognized that a well-developed system of social security provides some measure of safeguard against a drastic decline in income and employment. A well-designed social-security program helps to sustain purchasing power in depression periods and thereby contributes in a positive way to a higher level of real income.

In the case of public development and improvement projects, there is one aspect of the problem that deserves special consideration. It is generally admitted by everyone that public development projects that are self-liquidating can clearly be justified as a form of public expenditure which enhances real income. What is not always recognized is that public development projects that are not self-liquidating may be equally productive for the community as a whole. A toll bridge may be self-liquidating yet it surely contributes no more to the efficiency and productivity of the community than a free bridge which is not self-liquidating. A public high school could in many cases be self-liquidating if it charged fees from the pupils; but such a school would surely contribute no more to the productivity and efficiency of the nation than a free school.

Moreover, there are many public development projects that are abundantly profitable from the standpoint of the community as a whole even though they are not wholly self-liquidating in the narrow sense of that term. In the case of the TVA, for example, it has been said that the project may in fact return to the Treasury 100 cents on every dollar invested. Yet even though it should turn out to be true that the Treasury will receive in return only 50 cents on every dollar invested, it can be demonstrated that the project, from the standpoint of the nation as a whole, was nevertheless abundantly profitable. This

is true because the development of the Tennessee Valley area raised the productivity and real income of this entire area, opened up innumerable private-investment opportunities which would otherwise never have been available, and indirectly added to the purchasing power and income of the entire nation. Thus it is important, if we are to act in a truly statesmanlike manner with respect to problems of economic expansion, that we search out areas for public investment which will so contribute to the productivity and real income of the community as a whole as to justify the project from a strictly economic standpoint even though the direct return to the Federal Treasury falls short of the initial outlays.

Chapter Ten

FINANCIAL PLANNING, PUBLIC CREDIT, AND CYCLE POLICY

STATE and local governments must assume their appropriate share of responsibility for fostering economic progress and economic stability. It is evident, however, that the federal government must assume the leadership in a countercyclical program. It is the federal government primarily, in its expenditure, loan, and tax policy, which must act as a balance wheel offsetting the fluctuations in the private sector of the economy. Nevertheless, the state and local governments can do much in a supplemental way to promote economic stability. At all events, it is intolerable that the local units of government shall pursue policies which intensify the cycle, thereby forcing the national government to counter not only the fluctuations in private enterprise but also those of local governmental units.

Ideally, it would be desirable if the state and local governments could reinforce the federal government and follow a countercyclical policy involving flexible spending, borrowing, and tax programs. A careful analysis of the fundamental characteristics of state and local finance will reveal, however, that such a positive policy is difficult, if indeed not impossible, to carry through without federal aid. State and local units of government are severely limited in the essential powers requisite to an adequate countercyclical fiscal policy. The localities are particularly limited in their powers. State governments stand somewhat in between the federal government and the localities, with respect to cycle policy, but closer to the localities than to the federal government.

FUNDAMENTAL DIFFERENCES BETWEEN FEDERAL CREDIT AND LOCAL GOVERNMENT CREDIT

To begin with, the major expenditures of local units of government are essentially of a recurring nature, and for large municipalities this

is true even of public-work outlays. It is, therefore, not easy to fluctuate expenditures in accordance with the requirements of a countercyclical policy. On the other side, the revenues of local units of government do not lend themselves readily to rapid cyclical adjustment. Their tax structures do not respond quickly to fluctuations in income and employment. Nor is it possible for local units of government to utilize public credit effectively as an instrument for countering depression. Borrowing by local units on favorable terms is difficult and sometimes nearly impossible in depression periods when the private market for state and municipal bonds is restricted. The states and localities do not have at their beck and command a great central banking system as does the federal government, and this limits very severely the use of local public credit in periods of depression.

There are a number of fundamental differences between the federal government, on the one side, and state and local units of government on the other, which deserve close scrutiny and which have not infrequently escaped the notice of those who are concerned with public-finance problems. There are many things in the realm of fiscal policy that the federal government can do which state and local governments cannot do. Indeed, state and local units of government must in many respects be guided by the same financial precepts as those that should guide a conservatively managed private corporation. The federal government, on the other hand, has powers that vastly exceed those of private corporations or of local units of government. It is, therefore, in a position to engage in a vigorous expansionist program when local units of government and private business are unable to do so.

As noted above, a local unit of government is severely limited, compared with the federal government, in its use of public credit as a means of engaging in expansionist activities in a depression period. Superficially it has been said that there is no good reason why the citizens of a large municipality might not equally as well buy bonds from their city government to finance local improvement projects when in fact they are buying large quantities of federal bonds to finance federal projects or federal aid to local projects. There are, however, important differences. To begin with, the municipality is severely limited in its taxing capacity and consequently the credit of the city is not at all on a par with that of the federal government. In the second place, there is a fundamental difference between the economic effects

of the debt of a municipal government and the economic effects of the debt of the federal government. With a nation-wide capital market, only a small fraction of the debt of a city is held by its own citizens, whereas in the case of the federal government, the debt is almost entirely held by the citizens of the nation as a whole.

Basically, for most state and local units, borrowing is similar to the receipt by a national government of credit from abroad. Since to a large extent the funds must come from institutions and individuals located in other jurisdictions, the payment of interest and the repayment of principal involve a siphoning of income out of the local area and not merely a redistribution of income within the same community. Unlike the situation for the national government which borrows from its own citizens, the payment of interest charges involves a real cost to the members of a debtor locality. The fact that this is so does not imply, however, that states and localities should, under all circumstances, avoid borrowing. The net benefits to be derived from the expenditure of the borrowed funds may well justify the cost of borrowing. But the cost is, nevertheless, a real cost in the sense that to the extent that funds must be paid out to "foreign" individuals and institutions, such tax funds are not returned to the members of the locality itself.

Not only are these debt charges a real burden on the local community as a whole, but in addition, in view of the current regressive character of state and local taxes, the burden weighs particularly heavily upon the lower-income groups and thereby contributes to unequal income distribution. Yet even though this defect were remedied, we cannot lose sight of the fact that the debts of localities and states constitute a problem in public finance utterly different from that confronting the federal government in its use of public credit. Debt charges may seriously impair the ability of states and localities to support basic services.

With respect to the federal debt, its fundamental significance lies in the effect of the debt upon the distribution of the national income. It is important to note how the ownership of bonds is distributed, on the one side, and from what groups and economic classes the taxes are collected. A national debt held only by the rich, while taxes are levied only on the poor, would have a serious effect upon the workability of the economy, particularly in a society such as ours which under

ordinary circumstances needs to emphasize and to encourage consumption expenditures. The ownership of federal government bonds is in fact widely distributed, partly through mass holdings and partly through savings institutions, such as savings banks, life-insurance companies and the public trust funds, as well as through the commercial banks which perform a useful and highly necessary service *for the entire community and whose costs must be covered by adequate earnings*. On the other side, our federal tax structure is more progressive than the state and local ones. There is therefore reason to believe that our national debt has no seriously adverse effect on the distribution of income.

We have examined the difference between the use of public credit by local governmental units and by the federal government. Consider also the "leakages" involved in expenditures made in a local area compared with expenditures made in the nation as a whole. A private business corporation, for example, seeks to expand its activities in the midst of a depression. Any expansion engaged in, to be sure, adds that much to the total income stream and improves to that extent employment opportunities. But the benefit is spread very thin and is rapidly diffused over a wide area, and the corporation engaging in the expansion feels little or no effect so far as its own sales are concerned. Accordingly, a corporation which attempts to maintain normal operations under depressed conditions will rapidly find that the outgo of funds heavily exceeds the income for sales; eventually it will be driven into bankruptcy.

Much the same holds true for any individual local unit of government. A state or a municipality can affect the level of income within its own area only to a very limited degree. If one city alone engages in large public works, much of this primary expenditure will create employment in other areas. Moreover, the same is true of the secondary round of spending—the expenditures of the employees working on the site of the public works in question. The proportion of the new income spent on goods and services produced outside of the municipality, in a great national economy such as ours, will necessarily be very large. Geographic "leakages" dissipate widely the primary and secondary effects of the local public spending. So far as the primary effects are concerned, the production of construction materials is concentrated in

a relatively small number of industrial areas.¹ So far as the secondary effects are concerned, no local city in our highly interdependent modern society can supply any considerable proportion of the wants of its employed citizens.

Collectively, localities and states could accomplish a great deal if they engaged together in a concerted expansionist program. If this were done, the stimulating effect radiating out from each local unit throughout the country would flow back again from the entire nation to each locality, thus raising the total national income and increasing economic activity everywhere throughout the country. But such concerted action by all local units of government is difficult to achieve without direction and financial assistance from the federal government.

There are, moreover, technical reasons why state and local governments are more or less limited in the use of public capital expenditures to compensate variation in private investment outlays. For one thing, the need for various types of public improvements is of a continuing character and construction can, therefore, not easily be timed according to the requirements of the business cycle. Local communities cannot be expected to defer and to hold back in a long period of prosperity a large volume of public works if an urgent need for these facilities is currently present. This is particularly true of such urban improvement projects as water-supply systems and sewage-disposal plants, streets, schools, hospitals, and other public buildings.² Moreover, it must be evident that state and municipal capital outlays are tied more or less to the developments and construction activity of private enterprise. The building of new homes, shops, and factories usually necessitates an expansion of public facilities needed to service these private establishments. The stabilization of state and local capital outlays is, therefore, dependent in an important degree on the success achieved in narrowing the range of fluctuations in private construction.

Moreover, in a period of depression, the provision for large public works in a locality is seriously handicapped by the problem of financing. Large projects for special purposes must be approved by a vote of the community and such approval is frequently difficult to obtain when

¹ See J. K. Galbraith, *The Economic Effects of Federal Public Work Expenditures, 1933-38*, National Resources Planning Board (Washington, 1940).

² See Harold Wolkind, *Fluctuations in Capital Outlays of Municipalities, U.S. Bureau of Foreign and Domestic Commerce* (Washington, 1941), p. 31.

the financial affairs of the city are strained. In the past, the market for municipals has often been seriously restricted just at the time when borrowed funds were most needed.

From what has been said, it must be evident that states and localities cannot engage in a program of economic stabilization by themselves alone, but only as a part of an integrated program underwritten by the national government. Only the federal government is in a position to manage adequately the interrelated problems involved in carrying out a positive and flexible countercyclical fiscal policy. Nevertheless, the states and localities must make their contribution to such an integrated national program. Unless their fiscal systems are planned in relation to the federal stabilization program, they are likely to nullify in large measure the national countercyclical activities. In the past, states and localities have typically made large capital outlays in prosperous periods and have deferred capital improvements and even maintenance when business conditions were depressed. They have borrowed heavily when private capital markets were expanding and have curtailed their borrowing just at the time when new issues were needed to stimulate the economy. States and localities have in fact *followed* the swings of the cycle and have thereby *intensified* the violence of economic fluctuations.

States and localities should so order their finances in the various phases of the cycle that they will at any rate not contribute to economic instability. They must cease to go along with the cycle. As a *minimum* contribution to the countercycle program, they should stabilize their own expenditures over the entire business cycle. When we consider the fact that in the past state and local fiscal activities have aggravated the cycle, such a program would have important stabilizing effects. The maintenance of a stable expenditure pattern over the entire cycle would involve far greater state and local outlays in depression periods than have been made in the past. It would also involve restraint upon expanded construction programs in periods of prosperity when such activities contribute to inflationary pressures and rising costs.³ If the capital outlays financed by state and local governments were stabilized,

³ For a discussion of the desirability of "stabilizing" state and local finance, see John M. Clark, *Economics of Planning Public Works* (National Resources Planning Board, 1935), Ch. XI. Also Simeon E. Leland, "How May the States Prepare for the Financial Difficulties Ahead," *National Defense and State Finance* (University of Alabama, Bureau of Public Administration, 1942), pp. 164-176.

a rapidly expanded program of federal public works and improvement projects, together with federal grants to states and localities for enlarged public improvement programs in depression periods, could take up the slack in private capital expenditures. The construction industry as a whole, public and private, could thus be substantially stabilized.

PROPOSED CREDIT REFORMS FOR LOCAL GOVERNMENTS

The ability of local governments to follow a stabilized fiscal program will depend to a large extent upon improvements in three directions: (1) reduction of interest rates of local securities; (2) improvement in credit policies and facilities; (3) rationalization of debt-limitation provisions.

In spite of the recent decline in interest rates, high interest burdens for local governments are still an important limiting factor. In certain regions of the country, small governmental units which are dependent upon a local money market must pay exceedingly high rates of interest (in certain instances as high as 7 per cent or 8 per cent) so that they cannot borrow funds without burdening themselves with excessive carrying charges. In periods of depression even the largest local units may find themselves forced to pay exorbitant rates of interest in a restricted market.

The problem of short-term credit also deserves attention. In the depression of the thirties, short-term credit proved to be a critical problem for many cities and states. Rising tax delinquencies and declining assessed valuations, coupled with un-co-ordinated spending and taxing periods, were the major contributing factors. Improvements in tax-collection procedures and the integration of tax and expenditure years would go a long way toward solving the problem. At the same time, short-term credit facilities must not be left in their hitherto precarious position. The disruption of municipal activities which in the past has resulted from deficiencies in short-term credit facilities may occur again unless steps are taken to forestall the danger.

STATE SUPPORT OF LOCAL CREDIT

States have in the past extended aid to their subordinate governments through the support of municipal credit in various forms. The

methods employed have included state assumption of local debt, state payment of local debt service, state loans to local units, and state investment in local securities.⁴ In certain instances, states have assumed local debt by reissuing as state obligations bonds originally issued in the name of a subordinate unit. An example of this type of assistance is furnished by the assumption by Arkansas of \$64 million of road-district bonds in 1927. By 1940, Tennessee had refunded \$12.4 million of county debt through the issuance of state bonds.⁵ Another form of assistance has been the assumption of local debt service by state governments. Of chief importance has been the state servicing of county debts for highways which have been absorbed into state road systems. Delaware, which has largely centralized its school administration, is retiring the school debt. Such assistance is frequently related to a shift in service responsibilities rather than to the desire of states to aid local governments *per se*. As such, it must be judged in terms of the desirability of the shift in service responsibilities as between a state and its subordinate units.

More directly related to local debt policy is state assistance in the form of loans to their subordinate units. "The State of Washington since 1919 has extended from a revolving fund small loans to irrigation and drainage districts." In 1932, California loaned money to its counties for relief purposes. Massachusetts developed a program to ease the difficulty of local governments to obtain short-term funds. The state government extended credit to its localities in the form of one-year loans and on the security of their tax titles to delinquent properties. Although the state at first charged 4 per cent for the extension of short-term credit, it has since reduced the charge to the more modest rate of 1 per cent. "Any amount received by the state from interest in excess of the interest paid on state borrowings is returned to the cities and towns in proportion to the amount of interest paid by them to the state. . . . After deducting returned interest payments, the net interest cost to cities and towns varied from a rate of 0.15 to 0.20 per cent in 1939."⁶ North Carolina has extended loans for school-building construction. At least half of the expansion of \$86.4 million in the value

⁴ Wylie Kilpatrick, *State Supervision of Local Finance*, Public Administration Service, No. 79 (Chicago, 1941), pp. 43-46. This study is invaluable for its inclusiveness of data and interpretations.

⁵ *Ibid.*, p. 43.

⁶ *Ibid.*, p. 44.

of the public-school plant during the 1920's was made possible by state loans.

Another important form of state assistance to local credit has been state investment in local securities. State purchases of local bonds totaled \$1 billion in 1936.

In a sense state purchase of local securities is equivalent to state loans to cities or counties. State moneys are made available upon the sale of securities to state funds. The objective of securing a safe investment takes priority over financial aid to the local units. In many cases, however, the custodians of state funds can temper their choice of purchases so as to buy local securities in need of a good market. State assistance does not often take the form of low rates of interest. Interest is usually set at the prevailing market rate. Yet, local units which can sell their bonds on the market only at rates above the average are benefited by state purchases. During the depression, state purchases directly created a market for below-average districts and indirectly bolstered up the market for units which could dispose of their issues only with difficulty. The spread in bond prices between the low and best grade municipal bonds was lessened because the states purchased many of the poorer issues. State funds may be so administered as to secure important savings for communities in accrued interest, premiums, and past-due coupons.⁷

A suggestion for maximizing state assistance to local credit has been made by Mr. Wylie Kilpatrick. He proposes state-wide credit and reserve funds, created co-operatively with local units. Assets of state and local investment funds would constitute a single revolving fund to which the state could contribute from time to time by means of funds raised through borrowing. This money could then be released at favorable interest rates. "The loan function would be especially valuable in extending credit to small or fiscally embarrassed units and in supervising the finances of units in financial trouble."⁸ Such an arrangement would reduce the dependence of state and local governments upon market funds to a considerable extent. In the past, borrowing by local units has been necessary because their yearly demands for capital outlays have fluctuated so widely. By co-operative financing, the need for bond issues could be reduced to emergency programs, large projects, and self-liquidating enterprises. Thus the scope for pay-as-you-go financing would be greatly enlarged. State co-operative

⁷ *Ibid.*, p. 45.

⁸ *Loc. cit.*

reserves would be conducive to a fiscal stabilization program. Borrowing would supplement declining revenues in depression, while the high tax yields in prosperity could be utilized for the accumulation of reserve funds and the liquidation of the debt.

Although state-wide credit and reserve funds would go a long way in solving many pressing state and local credit problems in emergency periods, the use of federal credit is a desirable way of mobilizing the resources of all governments for a concerted antidepression program.

FEDERAL SUPPORT OF LOCAL CREDIT

The use of federal aid to support or supplement the credit of states and localities is well established. Starting from the assumption of the states' revolutionary war debt, through distribution of federal surpluses, to the complex banking institutions of the deep depression of the 1930's, there has been a fairly continuous historical thread of central assistance to local jurisdictions. During the thirties, a number of federal agencies came to the assistance of state and local units. The RFC and the PWA gave direct loans to nonfederal units and bolstered the market for their securities. The HOLC and the Federal Land Banks, through their support of property, bolstered the local tax base. The RFC and the PWA attacked directly the problem of extending credit to the states and localities. Both have excellent records as to defaults notwithstanding the emergency character of their loans.⁹

The experience of these agencies points to the desirability of establishing an Intergovernmental Loan Corporation. The purpose of such an agency would be to provide an adequate credit institution for state and local governments. It should be organized as an independent government corporation and should maintain standards of prompt

⁹ Through June, 1941, PWA had realized a profit of \$13,485,572 on its sales made to and through the RFC. *Annual Report of the Federal Works Agency, 1941*, p. 326. Out of a total of \$705 million of bonds purchased, only \$676,000 of principal and \$16 million of interest were delinquent on March 1, 1939. It was approximated that the "vast majority of these delinquencies can be corrected without serious difficulties." Public Works Administration, *America Builds* (Washington, 1939), p. 68. The RFC retired or sold the municipals it held including those purchased from the PWA at a premium of \$21 million. Of \$856 million of refinancing bonds to 632 agricultural districts, 99 per cent are current in interest and principal payments. These were the drainage, levee and irrigation districts which were defaulting in the early thirties. Reconstruction Finance Corporation, *Seven-Year Report* (February 2, 1939), p. 7.

payment of principal and interest by the local borrowing units. A permanent corporate institution could maintain sound financial standards more successfully than an emergency agency.

The corporation should be authorized to purchase the securities of state and local governments at a rate of interest which would reflect the cost of borrowing to the federal government plus a carrying charge (including in the computation of the charge, probable losses through defaults). This arrangement would put a ceiling on the cost of borrowing to the state and local governments. Such a ceiling would be important in emergency periods when the private capital market is restricted. The corporation should not be restricted to the financing of self-liquidating projects and should be authorized to buy the securities of any community whose economic capacity reflects ability to pay for the loan over a long period of time. Relief and education are as worthy of support as a utility or a toll bridge. Such a policy would encourage a better balance in community services and not force a bias in the direction of immediate revenue-producing projects.

The Intergovernmental Loan Corporation cannot and should not answer the underlying economic and governmental needs of declining and unstable communities. A long-run solution for their ills must come from different sources, possibly in the form of consolidation, programs of rehabilitation, industrialization, and temporary grants for specific purposes.

The establishment of an Intergovernmental Loan Corporation would help to free the state and local governments from pressures to resort to deflationary expenditure policies in depression periods—pressures from private bankers and investors to which they have had to yield in the past. The slashing of salaries and the abandonment of services should not be made a prerequisite for loan funds in depression periods. The long-term economic capacity of the borrowing community, and not the temporary state of its budget, should be the criterion for determining the credit worthiness of a local unit of government.

The Intergovernmental Loan Corporation should make use of the revolving-fund principle. Typically, securities should not be held for prolonged periods. They should be sold to the market as soon as the market can absorb them, thus making room for the purchase of other issues, particularly in an ensuing depression. This procedure would provide a greater incentive for the Corporation to impose standards

of fiscal soundness upon local units and would help to check excessively optimistic local programs, since the bonds would eventually have to meet the tests of the market. The state and local securities purchased by the Intergovernmental Loan Corporation might be made eligible assets upon which advances could be made by Federal Reserve Banks in so far as the particular issues in question were regarded as acceptable to the Banks. This plan would protect such securities in large measure from the instability of a cyclically sensitive market.

The Loan Corporation should specifically be authorized to purchase securities placed on the market by state and local reserve funds. This will tend to prevent depreciation in value of such securities in depression periods. If the downturn is sudden and severe, the bonds accumulated in the state and local reserves might be dumped on the market, with serious deflationary effects on the market and on security values. It is important, therefore, that the Loan Corporation be directed to purchase bonds offered by such reserves in emergency periods.

An important corollary of federal support of state and local credit would be to remove the only serious objection of those who have opposed the federal taxation of interest on state and municipal bonds; namely, increased costs of borrowing. Substantial advantages would be involved in subjecting the interest on municipals to federal income taxation, especially in broadening the income-tax base by closing an important loophole used particularly by wealthy taxpayers (the gain to an individual from such tax exemption is progressive according to his income bracket), and in encouraging investment in equities. Certainly, a basic and rational strengthening of the credit of states and localities is far preferable to an artificial subsidy which reduces the progressiveness and soundness of the tax system.

DEBT LIMITATIONS

Finally, the current legal debt limits on local governments possess neither economic nor political justification, and have in general been irrationally applied. In many cases, the present limitations are too rigid; in other instances debt limits have proved ineffective and communities have burdened themselves with excessive debt. Both these extremes can be avoided by placing debt limitations upon a rational basis.

Debt limitations have normally taken the form of a percentage of

assessed valuation of real property within the locality. This limitation, as applied, has had little meaning in some jurisdictions, but it has been applied in an unduly restrictive manner in others. This type of limit has many defects:¹⁰ (1) As a criterion of the capacity to finance debt services other measures than property assessments are important, including property-tax collections, revenues from all other sources, and the fiscal condition of the locality. (2) There are wide variations in the assessment ratio between different areas; little uniformity in debt control can, therefore, be achieved. (3) A local unit may arbitrarily raise its assessments in order to issue bonds after it has borrowed up to the legal limit. (4) Overlapping debt is not taken into account in applying the limitation. (5) Special assessment bonds and "revenue" bonds are generally exempted from the limitation. (6) In a depression, local debt margins decline with the shrinkage of property values, thereby impairing expansionist programs at just the time when they are needed and can be undertaken most economically. (7) Existing debt limits have led to an irrational and wasteful increase in the number of governmental units specifically created to borrow beyond existing debt margins.

These criticisms cannot easily be met by any single plan, but the method of control can obviously be improved. Instead of the limitation being a percentage of assessed valuations, the basis of the debt limit might better be a given percentage of revenues—including tax collections, fees and licenses, shared taxes, and surpluses from public-service enterprises available for general fund purposes—but excluding revolving-fund income from public-service enterprises and special-purpose grants from higher levels of government. This would give a far more accurate picture of the actual ability of the locality to meet debt services. Property tax collections in 1940, for example, ranged from 86.2 per cent of total revenues in Erie to 42.5 per cent of revenues in Tacoma. Any other individual revenue source will vary similarly between cities. Contributions from public-service enterprises in 1940 amounted to 30.3 per cent of revenues in Jacksonville, while a number

¹⁰ See Bureau of Government, University of Michigan, *State Supervision of Local Borrowing* Michigan Pamphlets No. 15 (1942), pp. 29-30. See also Leroy A. Shattuck, Jr., *Municipal Indebtedness, a Study of the Debt-to-Property Ratio* (The Johns Hopkins Press, 1940).

of cities had to cover utility deficits.¹¹ Such variations point to the necessity for including all revenues in the debt-limit base. A further improvement in the base could be achieved by using a moving average of a number of years, possibly five. This would permit reasonable planning on the basis of a more stable debt limit. If this proposal were adopted the debt margin would not contract so sharply in a period of depression and the scope for borrowing when the need is the greatest would be less seriously restricted.¹²

It should be clear that the chief objective of any local debt limitation is (or at least should be) to prevent the piling up of burdensome debt-service charges which would eat into the revenues of the localities and hamper flexible financing and programming. Debt service is a rigid item in local budgets, often rendering the financing of necessary social services difficult. There is no reason why the debt limitation should not be designed to fulfill its objective directly. Thus, the logic of the proposed limitation flows from the basic decision as to what percentage of revenues can be diverted to debt services without unfortunate consequences for the functioning of the local units. In determining the exact debt limit, two other factors must be taken into account: the average interest charges paid by localities within the state, and the average amortization period. Because these items change over time, the debt-limit regulations should be periodically re-examined.

Let us consider a hypothetical case. Assume that on the basis of a careful study of debt behavior and experience of the subordinate units of a given state, it is determined that local debt-service charges should at no time exceed one-fourth of local revenues. Assume further that the average interest charges on local borrowing, within the past three or four years, has been 4 per cent, and the average amortization period,

¹¹ U. S. Bureau of the Census, *Financial Statistics of Cities, 1940*, Vol. 2, Analytical Reports—Municipal Finances in 1940 (Washington, 1942), p. 18.

¹² Karl Scholz has demonstrated that if Philadelphia had introduced a nine-year moving average, as the base, the debt margin would have varied inversely with the cycle. The boom period would have found the city unable to borrow, while the depression would be characterized by an enlarged debt margin (Karl Scholz, *Municipal Borrowing Power, Debts, and Unemployment*, Pennsylvania State Planning Board, February 1937). The N.Y. State Constitutional Convention Committee proposed a five year moving average (New York State Constitutional Convention Committee, *Problems Relating to Taxation and Finance*, Vol. X [1938], pp. 307-311).

20 years. The maximum debt for communities within the state might then be set at approximately three times the average revenue (i.e., of the average annual revenues for the past five years), making some allowance for emergency purpose.¹³

The limit should apply to all debt serviced through the tax system. This would include "limited" and "special" tax obligations as well as unlimited tax obligations, and also deficits arising from projects financed by revenue bonds and defaults on special assessment bonds. That is, revenue bonds and special assessment bonds would be exempt from the debt limit only to the extent that the revenues from the project or system cover the debt charges (i.e., are self-liquidating); the tax-supported share should be subject to the debt limit. Short-term credit in the form of tax-anticipation notes up to, say, one-half of average revenues should also be exempt. To prevent these exempted items from becoming loopholes for evasion, high administrative standards would have to be enforced by Local-Government Commissions in each state.

As the debt approaches its maximum it should become progressively more difficult to borrow. Moreover, the limit should not be considered automatic, but rather should be subject to additional administrative control. No mechanical limit alone can be established which will provide effective control of municipal debt. Under the assumption made, a debt equal to 150 per cent of revenues might be authorized by council vote and a referendum. The second debt volume equal to an additional 125 per cent of revenues should require the approval of a state Local-Government Commission.¹⁴ Additional debt, amounting

¹³ The calculation is made on the basis of amortization through 20-year serial bonds, payable in equal annual installments. Thus, under the assumptions set up, the annual provision for debt retirement would be 5 per cent and for interest 4 per cent, or a total of 9 per cent. To determine the maximum debt which would involve debt service charges of no more than 25 per cent of revenues $9 \text{ per cent of total debt} = 25 \text{ per cent of average revenue}$, so that the total debt is $25/9$ times the average revenue.

¹⁴ North Carolina has had a very instructive experience with its Local-Government Commission. It must approve all bonds and notes. If rejected, the local unit may submit the issue for a referendum and overrule their decision. Even if approved by the commission, the issues must be brought before the people, if it is for purposes not classified as "necessary expenses," or if the issue would make the total borrowings during the fiscal year exceed two-thirds of the amount by which the outstanding debt of the local unit was reduced during the preceding year. Exceptions to this limit are funding and refunding issues, tax-anticipation notes not exceeding 50 per cent of predicted revenues, casual deficit notes, and loans to suppress riot and repel invasion. See James W. Fesler,

to 25 per cent of revenues, might be permitted for emergency purposes, possibly with the proviso that such funds be obtained from the Inter-governmental Loan Corporation. This type of reform¹² would place debt restraints on a more rational basis and would allow a greater degree of flexibility in credit management than now exists.

The use of state Local-Government Commissions or Departments is one of the most promising innovations in debt control. Administrative control combined with technical assistance is necessary to complement a statutory debt limitation. A Local-Government Commission, in addition to supervising debt-limitation provisions and managing co-operative reserves, could assist localities in marketing their securities, advise them with respect to debt retirement, assist refunding, standardize accounting procedures, and act as a service agency in many similar ways. The success which existing Local-Government Commissions and Departments have had with the flexible control of local finance points to the desirability of an extension of this technique for state supervision and control.

CAPITAL BUDGETS AND RESERVE FUNDS

In order to integrate state and local governments into a nation-wide program to promote economic stability and economic expansion, it would be extremely useful for these governments to undertake a rigorous reform in budgetary procedure. By reason of the special fiscal problems confronting state and local governments, it would contribute greatly to sound fiscal practice to set up a dual budget including (a) a current or operating budget and (b) a capital budget.

In considering the dual budget—(a) the current budget and (b) the capital budget—of a local government it will perhaps be helpful to start with the expenditure side. Current expenditures should all be entered in the current budget while capital outlays should be entered in the capital budget.

Capital expenditures are relatively easy to define. They involve "North Carolina's Local Government Commission," *National Municipal Review*, Vol. 20 (June 1941), pp. 327-334.

¹² A similar program of debt limitations has been suggested by Ben Rathford, *American State Debts* (Durham, N.C., 1941), pp. 572-599. Another well-conceived suggestion is presented by the Bureau of Government of the University of Michigan, *State Supervision of Local Borrowing*, pp. 37-42.

outlays for long-range projects involving investment in durable assets such as a school building, municipal water works, or a sewage-disposal plant. Capital assets have the important characteristic that they yield utilities to the community over a long period of time.

The budgeting of any capital asset involves two separate and distinct accounting procedures. One has to do with the initial outlay and the other with the continuing current items of expense occasioned by that initial outlay. The acquisition and continued ownership and operation of a capital asset, accordingly, involve two kinds of expenditures. One expenditure is entered in the capital budget and the other in the current or operating budget. The initial outlay involved in the acquisition of the asset is the expenditure item which is entered in the capital budget. On the other hand, the current expenditures, which the operation of this asset entails, are entered in the current budget. The current expenditures occasioned by the ownership and operation of a capital asset are (a) the cost of operating and repairing the capital asset, (b) the interest charges which must be paid on the investment, and (c) the depreciation or amortization charges required to replace the asset when it is worn out, or needed to pay off the debt obligation in the event that renewal or replacement is not desired.

It is for each local government to decide, in view of various conditions, whether it wishes to finance its capital outlays on a pay-as-you-go basis from taxes, or whether it wishes to finance by borrowing. In the case of small units, borrowing becomes necessary when nonrecurring large capital outlays are involved. In the case of a large municipality, even relatively large projects may be planned and initiated so as to permit a relatively uniform level of capital outlays from year to year, and thus make a pay-as-you-go policy feasible. But even when it is possible to spread out the projects evenly, borrowing may be quite justified. This is particularly true of self-liquidating public works but may also be true of non-self-liquidating or partially self-liquidating projects. The decision with respect to financing—taxation versus borrowing—must be made partly in terms of the prospects of future growth of the community and partly in terms of current and prospective needs. If a community has a high level of income and has reached stability in its growth, on balance it ought to operate on a pay-as-you-go basis. If a community has currently a relatively low income, but there are sound

grounds for anticipating growth and a rising real income for the community as a whole, there is greater justification for borrowing.

When borrowing is resorted to, the utility derived over many years from a capital project is paid for by the community year by year through taxes adequate to cover the interest charges and the amortization. When tax revenues are provided adequate to cover depreciation and interest charges on capital projects, a true balancing of costs and benefits over the lifetime of the capital project is achieved. The mere fact that interest is paid, in addition to depreciation or amortization charges sufficient to sum up eventually to the initial capital outlays, does not mean that the community is paying too much for the service rendered. Presumably, the services are worth, year by year, both the cost of interest and the cost of depreciation charges. Nor can it be said that the interest payments are made for services long since rendered and no longer present. This would be true only in the event that depreciation allowances had not been adequate to replace capital assets when worn out or obsolete.

But while interest payments under proper capital budget accounting are made for current services flowing from capital assets currently in use, nevertheless there is danger that interest payments may loom so large in current budgets that urgently needed community services cannot be provided. In so far as a local community can finance its capital projects, without borrowing, on a pay-as-you-go basis, the total benefits received currently from its capital assets will exceed its current costs. Such a community is therefore in a stronger position to provide needed services.

A community may, however, starve itself unduly of needed service facilities if it limits its public improvement projects to those which it can currently finance out of taxes. The whole problem is the familiar one of distributing income over time in terms of current income and current needs in relation to prospective income and prospective needs. It is a problem involving continuous judgment and planning for communities no less than for individuals.

There is thus a necessary interrelationship between the current or operating budget, on the one side, and the capital budget on the other. The operating budget must include as a part of its regular expenditures the depreciation, amortization, write-offs, and interest charges in-

cidental to the capital outlays which are accounted for in the capital budget.

The capital outlays entered in the capital budget are financed (a) by a special revolving fund of depreciation allowances transferred to the capital budget from the current or operating budget, (b) from general tax revenues transferred from the current or operating budget, and (c) from borrowing. This would be true, at any rate, if a local government financed its capital projects partly from taxes and partly from borrowing.

In the event that a local government was strictly on a pay-as-you go basis and financed all of its capital projects from current taxes, the revenue side of the capital budget would consist entirely of tax funds transferred from the current or operating budget sufficient to cover the capital outlays. In this event, no revenues would spring from borrowing nor from amortization or depreciation funds.

In the event that the local government financed its capital projects exclusively from borrowing, new capital projects would be financed entirely either by new issues or from the revolving depreciation fund transferred from the current or operating budget. In the event that capital assets were not growing and that new capital projects merely replaced abandoned or worn-out old ones, the new structures would be financed exclusively from the revolving depreciation fund.

The operating budget of a local government should be financed exclusively from taxes. This means, however, that the current or operating expenditures should be covered from tax revenues over the entire cycle. Even though the current or operating expenditures were stabilized, or expanding at a constant rate, it would, nevertheless, be difficult (and indeed unnecessary) to cover all current expenditures, year in and year out in all phases of the cycle, by tax receipts. While it is true that the tax revenues of local governments are relatively insensitive to fluctuations in income, nevertheless the fluctuations are sufficient to cause a deficit in depression years. Moreover, unless relief were financed exclusively by the federal government, this item of expenditure would rise in depression years. If the tax structure is set sufficiently high so that tax receipts (plus federal grants) cover total current expenditures over the entire cycle, a surplus of tax receipts over expenditures will occur in boom years and a deficiency of tax receipts in relation to expenditures in depression years. Thus, in view of the fluctua-

tions in the cycle, current expenditures cannot always be covered by taxes and some temporary resort to borrowing may be necessary.

If borrowing in depression years is resorted to by local governments, machinery should be devised to insure that the current budget is brought into balance over the entire cycle. In order to do so, it is necessary to amortize the loans temporarily made to cover the operating budget within a business-cycle period. In order to facilitate this, Sweden has devised a system of amortization of debt incurred to cover temporary deficits in the operating budget within a period of five years. Once borrowing is resorted to to cover a deficit in the operating budget, subsequent budgets in the succeeding five years are loaded with a sufficient amortization charge to repay the loan within that period. This procedure helps to insure a cyclical balancing of the current or operating budget and the rapid amortization of temporary loans.

RESERVE FUNDS

An alternative to resorting to borrowing in depression years, in order to cover expenditures in the current or operating budget, would be the accumulation of a reserve fund in prosperity periods sufficient to cover the deficit in depression years. A quite exceptional opportunity to build up such prosperity reserves is afforded in the current war period. Most local units of government could, under current conditions when the income of the individual members of the community as a whole is far in excess of the amounts that can be spent on currently available consumption goods, build up such reserves. Local taxes, under war conditions, should be increased in order to facilitate such a program. In a wartime inflationary period, the collection of taxes in excess of those needed to cover current outlays would help state and local units in postwar depression periods to maintain expenditures and to ease the burden of taxes.

The surplus funds could be used either to retire debt or to set up reserves for general or special purposes. In the event that debt is retired, interest charges in state and local budgets would be lower in the postwar period, and this would permit more generous support of basic services. Debt reduction would enhance the credit standing of the local governmental units, which would facilitate low-cost temporary borrowing in subsequent depression periods. If the debt is in the form

of serial bonds, and retirement would involve the payment of a premium, a sound principle would be to invest in federal securities which mature in those years in which the debt falls due.

In the current period, it is highly desirable that states and localities should build up reserves for postwar purposes and sterilize such reserves in dormant bank deposits and in federal government bonds. Either of two types of reserves might be employed—a capital reserve fund or a general reserve fund. Under the first arrangement, part of the current budgetary surpluses would be set aside to ease the financing of capital outlays in periods of depression. Another plan, suggested by William Stanley Parker, is that of establishing a general reserve fund which would be available for all budgetary requirements in depression periods, including current or operating expenditures, and not limited exclusively to capital outlays.

According to the Parker plan, such a reserve at the local level would be created by annual deposits, out of taxes, of 2 per cent of the authorized budget. Withdrawals from the fund would be on the basis of a formula aimed at determining the community's current ability to finance its normal activities. The formula suggested is based on three indices—assessed values, per cent of taxes collected, and welfare expenditures.¹⁶ It is interesting to note that Maine has enacted legislation to permit its towns to establish general reserve funds (similar to the Parker plan) and that similar legislation is being considered in other New England States.

Whether such prosperity reserves are built up to be expended in depression periods or the debt of local governmental units is reduced in prosperity periods and increased in depression periods, the net effect is substantially the same. The purpose of either scheme is to facilitate and promote the stabilization of expenditures over the entire cycle.

Only a few states have thus far explicitly established postwar capital reserves. Minnesota has set aside funds for highways, school programs and small-unit housing construction. The New York legislature has established a postwar capital reserve fund into which it is contemplated that various monies from bond issues and general-fund surpluses will be placed, accumulating to an eventual total of about \$300 million. Virginia is setting aside funds for specific projects. Henry F. Long

¹⁶ Massachusetts State Planning Board, Report of Committee on Public Works, *a Policy for Stabilizing Public Expenditures* (March 15, 1938).

reports that a state public-works reserve fund is "in the embryonic state" in Massachusetts.

Eleven states have authorized certain of their subdivisions to create reserve funds for future public works. Ambrose Fuller, who has prepared a comprehensive report on the subject of municipal capital reserves for the American Municipal Association, points out that although the majority of these states—namely, New York, Michigan, Washington, Kentucky, New Jersey (and Maine, Rhode Island, and Massachusetts)¹⁷—adopted their reserve fund laws in 1941 and 1942, the legislation is not a war idea. Oregon adopted a law of this kind in 1931, California in 1937, and Nebraska in 1939. "Thus it would seem," Mr. Fuller writes, "that this type of legislation has been more deliberately conceived as a phase of the development of municipal fiscal policies, as a means of avoiding the pitfalls of traditional long-term borrowing which have so often embarrassed municipalities in the past, and as a phase of the trend toward pay-as-you-go financing."¹⁸

It should be clear that without permissive legislation, localities—with the exception of "home rule" units—cannot legally accumulate cash reserve funds ("bootleg" reserves are not unknown). Specific or general authority must be found for tax levies for this purpose. If levies are sufficient to produce a surplus, authority is usually needed to permit its being carried over from year to year, otherwise surplus funds must be reappropriated in the following year's budget. These requirements prevent the establishment of public-works reserves out of either special levies or surpluses without permissive legislation. State legislation is necessary also to safeguard reserve funds, to prevent their dissipation for other purposes.

No considerable use has been made thus far of the state enabling acts permitting the setting up of reserves, but reports indicate that the present interest in the subject is greatly increased in the states which have authorized the creation of local reserves and that many additional funds may be expected to be established under these laws.

A number of congressional proposals have been made recently (e.g.

¹⁷ Mr. Fuller does not mention the Massachusetts permissive law which is a temporary war measure but is similar in general effect to the other state laws, nor the more recent Maine and Rhode Island legislation.

¹⁸ Ambrose Fuller, *Legislative Authorization for the Creation of Capital Reserves for Future Municipal Outlays*, Memorandum prepared for the American Municipal Association, Series AM, No. 26 (July 1942), p. 6

H.R. 1952 introduced in Congress February 23, 1943 by Mr. Rivers) to provide strong inducements, in the form of an attractive federal security for sale solely to state and local governments, for the accumulation of financial reserves for postwar use. There is a feeling in some quarters that we are too far along in the war to make the issuance of such a special security worth while. This may be true. On the other hand, the war may extend beyond present expectations, and, in addition, the years immediately after the war may be characterized by a continuation of inflationary pressures, making desirable the continued accumulation of budgetary surpluses.

We feel, therefore, that serious consideration should be given to the provision of a special Treasury issue for state and local governments. In order to encourage state and local governments to build up reserves and to sterilize such reserves in federal securities, it is recommended that the Treasury should make a continuous offering of four-year non-marketable notes. These notes would be available to state and local governments only, in unlimited amounts.

Interest would accrue on a graduated scale, compounded semiannually at rates that would increase from $\frac{1}{2}$ of 1 per cent for the first six months to 1 per cent for the next six months, and, by six-month periods, to $1\frac{1}{2}$, 2, $2\frac{1}{2}$, 3, $3\frac{1}{2}$ and 4 per cent. The notes would yield approximately 2.25 per cent per annum, compounded semiannually, if held to maturity (actually, 9.3485 cents on the dollar for the entire period). This compares with the yield of approximately 1.07 per cent on the Tax Series C which mature in three years.

A substitute issue might be five-year notes, with interest accruing on a graduated scale, compounded semiannually, at the following rates for each six-month period: $\frac{3}{4}$, $\frac{3}{4}$, $1\frac{1}{4}$, $1\frac{3}{4}$, $2\frac{1}{4}$, $2\frac{3}{4}$, $3\frac{1}{4}$, $3\frac{3}{4}$, $4\frac{1}{4}$ and $4\frac{3}{4}$ per cent. Such notes would yield approximately 2.5 per cent per annum, compounded semiannually, if held to maturity (i.e., 13.1986 cents on the dollar for the entire period).

In order to enable local governments to dispose of their holdings if that should become necessary, provision should be made for cash redemption including interest on 60 days' written notice, at any time after six months.

Such an issue would be very attractive to state and local governments. It would enable them to fill their entire demands at par as their funds

accumulated and would protect them from price risk. The rate of return would be attractive, and they would be able to solve the problem of maturity distribution. The notes would be redeemed on short notice either in total or serially to suit the convenience of the holders. Such an issue would offer inducement to state and local units to maintain their tax rates, build up reserves, and set aside such reserves for postwar depression use.

The budgeting of surpluses in periods of prosperity would require, at the local level, the setting of tax rates at levels which would provide yields somewhat above current requirements. This would require a plan along the line suggested by William Stanley Parker. It would be desirable, moreover, for all the local reserves within a state to be deposited in a single state-managed fund. Such a fund would permit a more diversified and stable financial investment program than the localities themselves could obtain. Moreover, such a fund would dramatize the objectives of the fiscal programs, and would permit establishment of better safeguards against the "raiding" of the local reserves.

At the state level, the budgeting of surpluses in periods of prosperity for use in depression can be facilitated by greater dependence on income taxation. The shift to income taxation suggested in a later chapter would enable the states to profit from the increasing volume of business and the increasing payrolls during prosperous years.

If states enter a depression period with insignificant surpluses and with heavy debt, their credit capacity is limited and they are forced to rely on cyclically insensitive taxes, chiefly sales taxes. Thus, they not only are unable to maintain their outlays and thereby provide employment and purchasing power, but they are forced to impose taxes which bear heavily on consumption. This vicious circle can be broken only by greater reliance on taxes that respond to business upturn, so that substantial budgetary surpluses become possible in prosperity—surpluses which can be used to maintain service expenditures and capital outlays in periods of depression.

At the local level, several improvements are currently called for: (1) assessment procedures need to be improved to permit prompt reassessment of properties favorably affected by business expansion; (2) most of the property exemptions now existing should be wiped out, and an improved and more standardized arrangement should be made of

"in-lieu-payments" for land and properties taken over by the federal government; (3) back taxes should be collected at once. If the accumulation of unpaid real-estate taxes are not wiped out during the currently favorable war period, they certainly will not be collected later.

To achieve stability, long-term *financial* planning is required. Under the long-range planning procedure suggested, future demands upon current revenues and upon borrowing power could be forecast with reasonable accuracy. The probable tax requirements of the years immediately following and the purposes for which such funds are intended could be made clear to the taxpayers. Authorization by the governing body or approval by vote of the people of bond issues or tax levies necessary to finance expenditure programs could be anticipated, and proposals submitted for consideration or vote well ahead of need. If enabling legislation or charter revisions were required before certain proposed improvements could be undertaken, steps should be taken in advance to secure the necessary action.

Because even the most stable of revenues fall in periods of depression, a stabilization program of the type described would require the planned budgeting of surpluses (debt retirement or special reserves) in prosperous years. Questions arise immediately as to how one recognizes prosperity, and what is to be done about relatively prosperous periods which fall far short of full employment and those which are short lived. There are no ready answers to these questions. These are, however, inescapable problems. They will confront private-business leaders and government authorities so long as economic fluctuations persist. We have no choice except to make the best adjustments possible. Uncertainty cannot be removed, but we can narrow its range.

Whether the deficit in current and operating budgets of local governmental units is financed from borrowing or out of prosperity reserves, support from the federal government could be implemented through the Intergovernmental Loan Corporation discussed above. Such a corporation could purchase securities sold by local governmental units from their prosperity reserve funds as additional revenue was needed to maintain current expenditures in the depression period. Alternatively, it could support the market for new securities issued in depression periods. The same argument holds for increased borrowing in depression periods incident to the stabilization of capital outlays for public works and public improvements.

LONG-RANGE PUBLIC-WORK PLANNING AND PROGRAMMING

If public-work expenditures are to be stabilized, physical developments and capital improvements in the state or locality must be undertaken within the framework of a carefully prepared long-range program. The foundation for such a program consists of the following: (1) studies of population and economic trends within the community and within the region; (2) a so-called master plan, which is essentially a comprehensive picture of physical goals, a picture of what the residents want their community to become, as well as a dynamic system of procedures; (3) analysis of individual projects—how they fit into the "master plan," estimates of costs, time required to build, amount of on-site labor to be employed, and so on. Upon such a foundation, individual projects can be fitted into a logical and balanced program. In essence, a long-term program of capital improvements is an estimate of capital needs for the next six years or other appropriate period, made up of new facilities, additions, or expansions judged to be necessary by the probable growth of population, as well as replacements that will become necessary because of depreciation and obsolescence. A distinction is made between construction that is postponable and that which is not. Each year the program is reconsidered, revised, and extended a year further into the future.¹⁹

A long-range capital program provides a sound foundation for stabilized fiscal policy. Fiscal decisions must, obviously, be made on the basis of long-term considerations. Tax policy as well as debt policy has to be made on the basis of judgments concerning future developments. The more exact the information on which these judgments are based, the wiser the fiscal policy may be. When future capital as well as service needs are clearly presented, long-term financial planning becomes a logical and indispensable corollary.

The long-range programming of state and local projects would be important also in enabling the federal government to carry out a flexible public-work program. It is assumed that the states and localities would themselves provide for the construction of projects when needed. At the same time, their long-range improvement plans would include

¹⁹ Benjamin Higgins, in *Postwar Economic Problems*, edited by S. E. Harris (McGraw-Hill Book Co., New York, 1943), pp. 187-205.

a number of projects which are desirable in the development of attractive communities, but which are deferrable and therefore would receive low priorities in the state and local building programs. If, in a depression, an expanded public-construction program is called for, the federal government might undertake to build such low-priority projects, or give grants so that states or localities might build them. Such a procedure would enable the federal government to expand public construction without the necessity for resorting to make-work (leaf-raking) projects. The federal government would be in a position to expand construction in precisely those areas that are hardest hit and are in greatest need of federal assistance. These considerations point to the desirability of the federal government actively fostering long-range public work planning by the states and localities. The national government should certainly provide technical assistance to the states and localities in the setting up of planning agencies and long-range programs. A new Public Work Reserve—a "shelf" of state and local projects—should be established, so that federal assistance could be put on a rational basis. Such a Reserve would enable the federal government to set up a priority system of its own in the making of grants for specific projects in depressed areas. It would also enable the federal government, through appropriate studies relating to the Public Work Reserve, to avoid freezing uneconomic situations (such as delaying migration where such migration is desirable), or protracting the "death struggle" of decadent communities.

We cannot now know what will happen when war production comes to an end. It is a matter of common sense that we be prepared to cope with mass unemployment and serious depression wherever these conditions threaten, as they sooner or later will. There is too long a history of violent instability in our economy to permit complacent optimism about the future. It is essential that there be on hand programs of public works of a magnitude comparable to the task that lies ahead. The plain fact is that, taking the nation as a whole, such programs are not now available.

The preparation of public-work programs—federal, state, and local, of the necessary magnitude and diversity—is a time-consuming task. Even if we were to start today, large sections of the programs could not be brought to the contract-award stage for some two to three years.

If public works are to answer the needs of the postwar period, the many thousands of individual federal and nonfederal projects must be prepared within the patterns set by several large over-all programs; namely, programs of urban redevelopment, of agricultural and resource development, and of transportation improvement. Unless the individual public-work projects are planned within the context of such over-all programs, they are certain to be limited in their scope and effectiveness. Not only would the nation fail to get the greatest returns on its investment, but the public investment opportunities themselves will be limited, so that we may fall far short of achieving full employment and full production.

Within the cities, projects—whether federal, state, or local—relating to slum clearance, housing, parks and recreation centers, transportation facilities (especially streets, parking spaces, and terminals), sewers, new schools and hospitals, and similar projects, should all fit into a master plan for the city. Master planning involves the setting forth of physical goals to be achieved and a complete land-use pattern (the desirable location of industry, commerce, public-service structures, parks and playgrounds, the various types of residential use—as well as the maximum permissible population density in each area). The buying of land and of rights-of-way is also an essential preliminary step to the construction of public-work projects within the cities. The time required for the drawing up of master plans will depend on the size of the city and the amount of data already available (such as real-property inventories). It is known that the great majority of our cities would require a *minimum* of 12 to 18 months to bring their planning to the project-programming stage—if they were to undertake an all-out planning effort (with adequate funds) immediately. The purchase of land and the completion of blueprints for specific projects will generally require additional time—in certain cases as much as an additional 12 to 18 months. Experience has shown that the alternative to such comprehensive planning are make-work projects of limited usefulness, limited employment creation, and limited stimulation to private investment.

In the field of transportation, most of the big public-construction projects—such as express highways, belt lines and bypasses, improved and modernized railroad terminal facilities, near-or-in-city airports, and river and harbor improvement—can logically be planned and blue-

printed only after the city master plans and river-basin programs are available. In the case of most of these projects, also, large tracts of land and expensive rights-of-way must be obtained before any construction work can begin.

From past experience it is known that, *on an average*, the cost of drawing up plans and specifications amounts to around 3½ per cent of the cost of the project—i.e., for every one billion dollars' worth of projects, some \$35 million are needed for planning purposes (including the collection of data and the drawing up of programs; such as land and water surveys, real-property surveys, and city master plans, as well as project blueprinting). It can be expected, therefore, that some \$350 million will be required to set up a reserve shelf of state and local public works containing \$10 billion of postwar projects.

An aid to planning and programming is proposed in the Lynch bill, introduced May 24, 1943,²⁰ and referred to the Committee on Ways and Means. This bill provides, first, that a sum not less than \$10 million be appropriated annually for payment to the states and their political subdivisions to aid them in making comprehensive plans and programs for the development of their areas. It is intended that this sum should aid state and urban planning agencies to make comprehensive master plans. In the second place, the bill authorizes the appropriation of \$75 million to states and local governmental units to make engineering plans and specifications for specific public-works and improvement projects. It is intended that this should expedite the selection and inauguration of public-works and improvement projects in the postwar period. So far as urban master planning is concerned, however, it is believed that cities would and could finance this if they were stimulated to do so by a federal urban redevelopment program such as that proposed in the Thomas bill and discussed in Chapter VI above.

²⁰ H.R. 2783, 78th Congress, 1st Session.

Chapter Eleven

THE EXPENDITURE BUDGET IN A FEDERAL SYSTEM

IN THIS chapter we shall consider the over-all budget of government in the United States at all three levels, federal, state, and local. In the succeeding chapter we discuss the over-all tax structure. In a federal system in which transfers of funds are made between the various levels of government, there will be considerable divergence between the amounts expended on functions administered by each governmental unit and the amounts raised by taxes and borrowing at the different governmental levels.

In Chapter IX we have discussed the role of government expenditures in income creation and in Chapter X the problem of financial planning with respect to the business cycle. In this chapter we shall discuss different budgetary models setting forth programs of useful and productive expenditures, varying within appropriate ranges according to the requirements of economic stability.

One cannot appraise the economic significance of the over-all governmental budget, whether on the expenditure side or on the revenue side, without placing it against the background of the national income and the gross national product. In order to obtain a sense of proportion, it is necessary to know the magnitude of the economy within which given governmental budgetary programs are intended to operate.

The Gross National Product is a concept which has only recently come into general use. This concept indeed became absolutely necessary as soon as governmental outlays during the war period began to play an overwhelmingly dominant role in the whole national economy.

The Gross National Product represents the total monetary value of all goods and services produced whether by private individuals and business units or by government. It is a broader concept than that of the national income. The national income, as this concept has evolved

over the last couple of decades, has come to mean income payments to individuals plus net corporate savings. The term "income payments to individuals," or more briefly, simply "income payments,"¹ has increasingly come into wide use and is a very useful concept since it gives us the magnitude of the flow of income received by individuals.

The Gross National Product—the value of all goods and services produced, including replacements of capital goods—is equal to (a) the income payments to individuals, (b) gross business savings (adjusted), and (c) business taxes.

A simple illustration may help to clarify this concept. Let us assume that all physical goods or commodities are produced by a single corporation and that all personal services are produced by the government. Let us assume further that the government services are financed entirely by taxes paid by the business corporation; that the government services cost \$20 billion and that the corporation produces physical goods having a market value of \$120 billion, of which \$100 billion are sold on the market to the public while \$10 billion are a net addition to its capital plant and equipment, and another \$10 billion are capital replacements. The corporation pays to all its employed factors (including stockholders and wage and salaried workers whether making the final goods or engaged in construction of plant and equipment) \$80 billion. It pays \$20 billion business taxes. From this revenue the government is able to pay its employees \$20 billion to perform the government services.

It is evident that the income receipts of individuals are \$100 billion (\$80 billion paid by the corporation and \$20 billion by the government). These individuals spend their entire income, it is assumed, on the products sold by the corporation. Of the gross sales of the corporation—\$100 billion—\$20 billion are paid in taxes and \$80 billion to employees and stockholders.

Evidently the value of all goods and services produced—Gross National Product—is comprised of the following:

¹ Our "adjusted income payments" concept differs slightly from that of the Department of Commerce. It includes payroll taxes and excludes "transfer payments," i.e., payments for relief, pensions, food stamps, veterans' bonus, and from social-insurance funds. These more or less offset each other, our figures for income payments are substantially similar to those of the Commerce Department. Cf. *Survey of Current Business*, August 1943, p. 13.

The market value of goods sold by the corporation	\$100 billion
The value of capital goods produced and retained, replacement and new	20 billion
The value of government services	20 billion
Total	<u>\$140 billion</u>

The Gross National Product can be divided as follows:

Income payments to individuals (\$80 billion paid by corporation and \$20 billion by government)	\$100 billion
Gross business savings (adjusted) ²	20 billion
Business taxes	20 billion
Total	<u>\$140 billion</u>

Again the Gross National Product may be divided into the following categories:

Private-consumption expenditures	\$100 billion
Private-investment outlays	20 billion
Government expenditures	20 billion
Total	<u>\$140 billion</u>

While the Gross National Product is \$140 billion, the Net National Product after deducting for the replacement capital outlays is \$130 billion. Thus there emerges four useful concepts:

- (a) Gross National Product
- (b) Net National Product
- (c) National Income ("income payments" plus corporate net savings)
- (d) Income Payments to Individuals

With this somewhat technical analysis of concepts behind us, we may now consider the development and constituent parts of the Gross National Product in the years 1929, 1941, and the estimated figures for 1943 and 1944. Table 43 divides the Gross National Product into the

² Gross business savings, as here used, do not include the *net* savings of unincorporated business, since these are a part of "income payments." Gross business savings include (a) net savings of corporations, and (b) depreciation and other reserves of all business units, whether incorporated or not.

following constituent parts: (a) income payments to individuals, (b) gross business savings, and (c) business taxes.

TABLE 43. Gross National Product by Disposition of Funds

(in billions of dollars)

	1929	1941	1943	1944	Postwar 1947
Adjusted income payments to individuals *	82.1	92.2	142	154	132
Gross business savings	10.3	8.7	16	16	15
Business taxes	7.0	18.3	29	30	13
Gross national product	99.4	119.2	187	200	160

Sources: 1929 and 1941, *Survey of Current Business*, May 1942, p. 12, and August 1943, pp. 12-13. Estimates for 1943 and 1944 are based on "National Product and Income in the First Half of 1943" by George Jaszi, *Survey of Current Business*, August 1943, pp. 9-14, January 1944, and other sources. Data for the postwar year are in accordance with our Model IV, Table 47 of this chapter, and Table 50 of Ch. XII.

* Adjusted income payments equal income payments as used by the Department of Commerce, plus payroll taxes and minus transfer payments (see footnote p. 224). The adjustment is made here in order to simplify the table.

Table 44 below divides the Gross National Product for the years in question into the following categories: (a) private-consumption expenditures, (b) private-investment expenditures, (c) government expenditures (corrected for transfer payments, etc.). Private-investment expenditures include both those made by corporations and by individuals. For example, in 1929 private-investment expenditures included not only the capital outlays made by corporations but also the capital outlays made by individuals on housing, as well as those made by unincorporated businesses. It should be noted also that corporate and individual savings may not be expended on private investment. Thus in 1943, corporations, business units, and individuals made virtually no capital outlays. Corporations were saving not only their depreciation allowances and other sums set aside in reserve, but were also retaining a substantial part of their net corporate profits. These savings instead of being expended on capital goods were largely invested in government securities or other forms of financial investment or were held as bank deposits.

In this table it is anticipated that the Gross National Product in

TABLE 44. Gross National Product by Origin of Expenditures

(in billions of dollars)

	1929	1941	1943	1944	Postwar 1947
Private-consumption expenditures	70.8	74.6	90	86	106
Private-investment expenditures	17.6	19.0	1	0	24
Government expenditures for goods and services	11.0	25.7	96	114	30
Gross national product	99.4	119.2	187	200	160

Sources: 1929 and 1941 are from *Survey of Current Business*, May 1942, p. 12, August 1943, p. 13 and January 1944. Other data are our own estimates.

1944 will be double that in 1929. This assumes a price level only very slightly above that of 1929. The income payments to individuals will have increased about 80 per cent, while private-consumption expenditures will have increased about 20 per cent. The wide discrepancy between income payments and private-consumption expenditures in the war years is represented by the great increase in personal taxes and savings by individuals.

In 1929, government expenditures were \$11 billion out of a Gross National Product of \$99 billion. In 1944, it is estimated that government expenditures will comprise \$114 billion out of a Gross National Product of \$200 billion. Private expenditures (on both consumption and capital outlays) were about \$88 billion in 1929, and are estimated at \$91 billion in 1943. That private-consumption expenditures had risen from \$71 billion in 1929 to \$90 billion in 1943 is made possible partly by the drastic decline in private capital outlays. During the war, the construction of nonmilitary plant equipment, housing, etc., has virtually stopped.

In the postwar period, we must expect some substantial decline in the Gross National Product. This follows mainly from the following facts: (1) Some substantial number of those employed in civilian and military activities (about 62 million in 1943) will drop out of the labor market. (2) Overtime work will largely be eliminated. (3) There will be a movement from the high-wage war industries to relatively lower-wage civilian industries, as for example from shipbuilding to trade and service industries. (4) Some increase in the amount of un-

employment (even under theoretical "full employment") may be regarded as unavoidable under peacetime conditions, owing to normal labor turnover, transitional shifting of labor geographically and industrially, and seasonal unemployment.

It is estimated that after taking account of these factors it should be possible, at a price level substantially similar to that of 1929 or 1942, to produce a Gross National Product of \$160 billion. With very substantially lower business taxes than those of wartime, this should make possible income payments (receipts of individuals) of \$132 billion.

In this chapter the government expenditures suggested above are based on tentative estimates, which are believed to be self-consistent and reasonable, of the probable role which government needs to play in order to sustain full employment in years of moderate levels of private-investment activity. They involve, moreover, a preliminary analysis of the expenditures which governments must make in order to supply the governmental services required to maintain the standards of community services needed in a highly developed modern industrial society and to develop the human and material resources necessary to promote increasing productivity and rising living standards.

In Table 45 is presented a tentative budget for (a) the federal government, (b) the state governments, and (c) the localities, for the various categories there enumerated. The total for all three levels of government is \$36.0 billion.³ This may be compared with \$23.5 billion in the fiscal year 1941, when military outlays amounted to \$6.7 billion. Of the proposed postwar budget, \$23 billion are expended by the federal government for its own functions, \$3.6 billion by the state governments, and \$9.4 billion by the local governments. These figures, as already indicated, do not disclose at what levels of government the funds are raised. Intergovernmental transfers must be made to permit the localities to expend a sum of the magnitude indicated without raising impossible problems of local taxation.

The expenditure categories enumerated fall into four broad classes. These four categories for all governments combined are as follows:

³ The difference between this figure and the expenditures on government services included in arriving at the Gross National Product is accounted for by the transfer payments, which are here assumed at \$6 billion and which are no part of the Gross National Product.

1. Human betterment and service expenditures	\$13.7 billion
2. Improvements in material resources and facilities	7.0 billion
3. Military and other protection	6.8 billion
4. General governmental expenditures including interest on the public debt	8.5 billion
Total	\$36.0 billion

The postwar expenditures of the local governments are estimated at around \$9.4 billion. This figure compares with \$6.7 billion spent in 1941. The main increase is due to considerably larger educational expenditures, and to outlays on urban redevelopment and improvements. The local governments, it is assumed, would raise about \$5.3 billion in tax and nontax revenues (other than borrowing), or exactly the amount so raised in 1941. The difference between the proposed expenditures and revenues would be made up from transfers by the federal government and the states, and partly from borrowing, especially by the local public-service enterprises.

The educational expenditures of the localities are increased by \$1.4 billion (including an allowance for construction of schools of about \$400 million), the increase being furnished largely from federal funds. The expenditures for urban redevelopment would be financed chiefly by aid from the federal government.

The total expenditure budget of the states for the postwar period, it is assumed, would amount to \$3.6 billion as compared to \$2.7 billion in 1941 (after deducting expenditures for unemployment insurance, here transferred to the federal government). The main changes of the state budget involve an increase in expenditures for public improvements, education, and welfare. It is assumed that the tax revenues of the states would exceed the expenditures on their own functions.

The proposed postwar budget would involve a considerable increase of transfers among the three levels of government. The transfers from the federal government to the states and localities would amount to \$3.0 billion. These compare with federal transfers of \$900 million in 1941, exclusive of federal aid to local construction projects through the Work Projects Administration, amounting to about \$850 million.

Most of the transfers of funds from the federal government, with the exception of the funds for urban redevelopment, would be made to the states, and largely retransferred by the states to the localities. The

TABLE 45. Postwar Over-all Budget

(moderately high levels of private investment are assumed)

(in billions of dollars)

	All Govts.	Federal (own func- tions)	State (own func- tions)	Local (own func- tions)
Total cost payments	36.0	23.0	3.6	9.4
Military outlays, protection	6.8	6.0	0.2	0.6
Veterans' benefits	2.0	2.0		
Social insurance:	3.5	3.5		
1. Old age				
2. Permanent disability				
3. Unemployment				
4. Temporary disability				
Health	2.6	2.0	0.3	0.3
1. Health insurance				
2. Public health services				
Public assistance	1.6		0.8	0.8
Education	4.0		0.5	3.5
Public development and im- provement projects:	7.0	2.5	1.5	3.0
1. Transportation				
2. Forestry				
3. Agriculture and soil conservation				
4. Irrigation				
5. Flood control				
6. River-valley develop- ment				
7. Lending operations— rural electrifica- tion, etc.				
8. Urban redevelopment				
9. Public housing				
10. Public-service enter- prises				
11. Other Public works				
12. International loans and development projects				
Interest on public debt	6.6	6.0	0.1	0.5
Residual overhead adminis- tration	1.9	1.0	0.2	0.7

necessity for this setup is evident in view of the fact that two kinds of equalization are usually included: first, an equalization between the various states; and second, equalization within a state. The latter would necessarily have to be under the control and direction of the states.

Thus the great majority of the funds transferred from the federal government to the states—more specifically the funds for health, welfare, and education—will flow through the states and be spent by the localities. Federal grants for public assistance would include federal support to the localities for general relief in the form of a unified variable grant. The federal support for education would amount to \$1 billion or about 25 per cent of total expenditures for education. Finally, there would be a federal grant to the states to assist them in their general public-works program and to help finance developmental projects on the state or local level.

Proposed federal transfers to states and localities, together with the expenditures by the federal government on its own functions, are shown in Table 46.

A FLEXIBLE BUDGET

Cycle policy involves fundamentally, on the one side, an expansion of public expenditures when depression threatens and, on the other side, a reduction of tax rates. When excessive boom or inflationary tendencies are present, cycle policy involves a curtailment of expenditures and an increase in tax rates.

The over-all budget of all levels of government presented above may tentatively be regarded as appropriate for fairly good levels of private-investment activity. This would imply that the expenditures would be curtailed in periods of high private-investment activity with inflationary tendencies and, on the other side, would be increased substantially in periods when private-investment activity drastically declined. On the taxation side, it is suggested that the normal income tax, which applies broadly to the whole population and which is collected at the source, constitutes a very effective compensatory device. The rate should be raised and lowered to check or to stimulate the flow of private-consumption expenditures so as to offset fluctuations in private investment and to promote economic stability at full employment levels.

TABLE 46. Federal Postwar Budget

(moderately high levels of private investment are assumed)

(in billions of dollars)

	Federal Ex- penditures on Own Functions	Grants to States and Localities	Total
Total cost payments	23 0	3 0	26.0
Military outlays	6 0		6 0
Veterans' benefits	2 0		2 0
Social insurance:	3.5		3 5
1. Old age			
2. Permanent disability			
3. Unemployment			
4. Temporary disability			
Health	2.0	0.2	2.2
1. Health insurance			
2. Public health services			
Public welfare		0.8	0.8
Education		1.0	1 0
Public development and improve- ment projects	2.5	1.0	3 5
1. Transportation			
2. Forestry			
3. Agriculture and soil conservation			
4. Irrigation			
5. Flood control			
6. River-valley development			
7. Lending operations— rural electrifica- tion, etc			
8. Urban redevelopment			
9. Public housing			
10. Public service enterprises			
11. Other public works			
12. International loans and de- velopment projects			
Interest on public debt	6.0		6 0
Residual overhead administration	1 0		1 0

State and local expenditures, as already explained, are less subject to variation in the various phases of the cycle than is the federal budget. The fluctuations must, therefore, largely be made in the federal budget.

The areas that are mainly subject to variations in expenditure are the public development and improvement projects, including transportation, resource development, reforestation, soil conservation, irrigation, flood control, river-valley development, urban redevelopment, public housing, international loans and development projects, and to a limited extent certain special types of outlays on military capital facilities. The combined expenditures in this area might be fluctuated by several billions, providing a sufficient range of flexibility to achieve substantial stability in the construction industry as a whole, public and private.

At a \$135 billion national income, we assume net savings of individuals and corporations of \$15 billion—\$12 billion by individuals, and \$3 billion⁴ net corporate savings. In view of the higher taxes in the postwar period compared to prewar, only time can demonstrate what the volume of savings would be at so high an income level. On the basis of past experience and numerous statistical analyses, together with the probable effect of the war upheaval upon postwar savings, the figure suggested is believed to be a reasonable one.

A moderately high level of net private investment may be estimated at about \$12 billion,⁵ compared with about \$8 billion in the late twenties. In order to take up the flow of net corporate and individual savings of \$15 billion, \$3 billion of federal government issues (in addition to the \$12 billion private capital outlays) would be necessary to maintain income and employment.

If \$15 billion of savings is the amount the economy generates at an income level of \$135 billion, then it follows that this volume of saving must fully be absorbed either in private investment or in new government issues, else income and employment will decline. It is incorrect to say that all that is necessary is to see to it that investment equals saving. The point is that the volume of savings generated by the economy varies with the income level. At a very low income level, net savings

⁴ This figure is for all corporations including those having losses. The retained earnings for the corporations making profits would be considerably higher. Net corporate average savings in 1926-29 (Kuznets) was only \$1.4 billion. At a national income of \$135 billion, corporate losses would be relatively small, accordingly, net corporate savings of all corporations of \$3 billion may be regarded as reasonable.

⁵ Our figure for private net investment, strictly speaking, is \$11.2 billion, since we have more or less arbitrarily included in this figure the net new issues (over and above refunding issues) of states and localities. It is suggested that these might amount to say \$800 million.

may indeed be zero, and if investment is also zero, the income will be stabilized at this low level. What is necessary is that private investment must be equal to the savings that are generated at a high employment level. When private investment falls below this level of savings, income and employment necessarily will decline unless government issues absorb the excess of saving over net private investment.

At boom conditions of private capital outlays with a national income at \$140 billion and net savings at say \$16 billion, we may assume all of the savings to be absorbed by private investment (and by local issues including local public-service enterprises). No new federal issues would then be required. At this point the federal budget could be balanced without upsetting the economic balance. The federal budget could be balanced partly by curtailing the expenditures in the compensatory budget, having to do mainly with construction activities, and partly by an increase in the normal income-tax rate.

If the burst of private investment should reach inflationary proportions, the federal budget might be reduced to, say, \$22 billion, and federal tax receipts increased to \$27 billion. If, on the other hand, net private investment should fall drastically, to say around \$4 billion annually,⁶ it would then be necessary to reduce the normal income-tax rate and selective excises and, on the other side, to increase federal expenditures to perhaps \$29 billion. This would require new governmental issues adequate to mop up the surplus of savings—about \$10 billion—over and above the amount absorbed by net private investment.

Thus the range of a compensatory tax and spending program might well run from a federal budget of \$22 billion in peak private-investment years to \$29 billion in low private-investment years, while, on the other side, the federal taxes might run from \$19 billion in low private-investment years to \$27 billion in high (inflationary) private-investment years. The result would be a fluctuation in the federal budget ranging from a deficit of \$10 billion in the worst private-investment years to a surplus of \$5 billion in years of feverish investment boom, with an intermediate position requiring about a \$3 billion annual government deficit in order to absorb the excess of saving which the economy gen-

⁶ It should be noted that in 1932, net investment had fallen to a level far below zero, in other words, net investment was a minus quantity, indicating that capital was being consumed at a rate far in excess of capital replacements.

erates at full-employment levels over the volume of private investment.

The compensatory fiscal program, involving both fluctuations in taxes and in expenditures, described above, is summarized in Table 47 below. Four levels of private investment are assumed. The range is from a low of \$4 billion to a high of \$23 billion, with two intermediate levels of \$12 billion and \$16 billion.

It will be noted that in the table it is assumed that the income fluctuates relatively little despite the rather wide range of fluctuation of private investment. This, of course, follows from the assumption that vigorous compensatory fiscal action has been taken in order to offset the impact of fluctuations in private investment upon the economy. Were this *not* done, the fluctuations in private investment indicated would have a profoundly unstabilizing effect upon the national income. Indeed, if the compensatory fiscal action were not undertaken, we can be certain that the fluctuation in private investment itself would be very much greater than here indicated. This follows from the fact that when compensatory action is taken, the fluctuations in private investment are minimized.

When no compensatory action is taken, once a decline in private investment begins, it is likely to cumulate into a deflationary spiral, as occurred from 1929 to 1932. Such a deflationary spiral results from the fact that once private investment seriously falls, this in turn induces a sharp decline in private-consumption expenditures, which in turn induces a further decline in private investment. If, however, the decline in private investment is compensated by vigorous fiscal policy so that income and employment are substantially maintained, then the cumulative deflationary aspect of the private-investment decline can be largely eliminated.

At a full employment equilibrium level of private-investment activity (a level at which net investment equals net private savings) the governmental budget should be balanced, since all private savings are absorbed in private investment and there is no room for new governmental issues. At this level we assume federal expenditures of \$24 billion and taxes of \$24 billion. These figures are given in Model I, Table 47.

In Model II we assume a sharp decline in private investment to \$4 billion with a government deficit of \$10 billion to absorb the excess saving. Here we assume federal expenditures of \$29 billion and taxes

TABLE 47. Federal Budget in the National Economy
(in billions of dollars)

	Net Private Investment (over and above re- placement capital outlays) *	Federal Expendi- tures	Federal Taxes	Federal Defi- cit (-) (re- quiring new govt issues) or Surplus (+) (involving debt retire- ment)	Net Sav- ings of Individuals and Corpo- rations †	Assumed National Income (re- sulting from com- pensatory fiscal program)
Model I						
High private investment equal to net savings of individuals and corpo- rations at a full em- ployment income	\$16	\$24	\$24	0	\$16	\$1.40
Model II						
Low private investment (\$10 billion below the level of savings which must be absorbed to provide full employ- ment)	4	29	19	-10	14	125

* The replacement capital outlays as here used are those financed from business depreciation and other reserve funds. For convenience there is included in the net private-investment figure as here given the new issues (net) of state and local government. See table 48, p. 241.

	<i>(in billions of dollars)</i>					
	Net Private Investment (over and above replacement capital outlays) •	Federal Expenditures	Federal Taxes	Federal Deficit (-) (requiring new govt. issues) or Surplus (+) (involving debt retirement)	Net Savings of Individuals and Corporations †	Assumed National Income (resulting from compulsory fiscal program)
Model III						
Feverish private-investment boom with investment outrunning normal savings at full employment	23	22	27	+5	18	150
Model IV						
Intermediate level of private investment; new government issues necessary to absorb savings not used by private investment	12	26	23	-3	15	135

† The figures in this column are given here in round numbers for illustrative purposes. Obviously the figures if derived from a regression line of the savings income function would be slightly different

of \$19 billion. This spread is brought about by a reduction in the normal individual income-tax rate, and on the one side an increase in expenditures, particularly in the area of public development and improvement projects.

The reduction in normal income taxes which come mainly from the mass of the people places increased purchasing power in the hands of consumers, thereby offsetting the depressional effect of the decline in private investment. Moreover, the expansion of the public development and improvement projects operates powerfully in the capital goods industries to offset the depressional tendencies. This double-edged action can be expected to have a strong stabilizing and employment-sustaining effect. It may thus reasonably be assumed that the total national income, while falling somewhat, could be rallied at a level of, say, \$125 billion.

The fall in income, even though moderate, is likely to produce a decline in savings, especially the savings of corporations. It is accordingly assumed that the net savings of individuals and corporations will drop from \$16 billion to \$14 billion.

In Model III, it is assumed that strong recovery in private investment has occurred which indeed moves on into the feverish stage in which inflationary tendencies are present. Here private investment tends to outrun savings, thus creating an inflationary situation. At this point it becomes necessary to undertake a strong anti inflationary action which, on the one side, would tend to curtail the excessive private-investment activity and, on the other side, tend to curtail consumption and add to the volume of saving. This goal can be achieved by creating a budgetary surplus. We assume federal expenditures reduced to \$22 billion and federal taxes increased to \$27 billion. The increase in taxes should come mainly from an increase in the normal income-tax rate and partly from extraordinary excise taxes.

These taxes would be strongly anti inflationary since they would impinge mainly upon consumption expenditures. Curtailment of consumption would, in turn, tend to check the excessive investment boom. On the other side, the fact that the federal debt is being reduced through the retirement of bonds means either that bonds held by banks are retired (which would deflate demand deposits) or that other bondholders are now provided with cash funds. This latter may tend to in-

crease somewhat the volume of savings.⁷ With savings somewhat higher (an increase from \$16 billion to \$18 billion) and with investment checked by the curtailment of consumption, the inflationary tendency could be stopped at a higher income level—a level at which investment and saving are again in equilibrium. Such a high level of private investment, we can be sure from past experience, is not likely to last long. Thus the inflationary tendency will sooner or later disappear and the economy would thus fall to lower levels.

In Model IV, an intermediate level of net private investment is assumed of \$12 billion (over and above the replacement capital expenditures). It is quite impossible to forecast what level of private investment could for long periods be continuously maintained. It is clear, however, that \$12 billion of net private investment, year in and year out, is an enormous amount, and even this volume will doubtless be regarded by many as excessively optimistic if one expects the level to be maintained for any long period of time. In this connection it should not be forgotten that the enormous volume of new plant facilities made necessary by the prodigious war program amounted in total to only \$18 billion, spread over three or four years, or about \$5 billion per year. Nor should it be forgotten that the total prewar investment in the automobile industry was about \$2 billion, and that the total investment in the Tennessee Valley Authority when completed will amount to only about \$1 billion. Those are gauges from which one may make some judgment about the vast volume of investment which \$12 billion net, over and above capital replacement, would provide year in and year out.

If the level of private investment which could be maintained for long is around \$12 billion, and if private savings at the assumed income of \$135 billion are \$15 billion, it is clear that new government issues would have to take up the difference unless ways and means were found of raising private consumption and reducing the volume of savings. Until this were accomplished, whether by deliberate action or by automatic adjustment, new government issues would have to

⁷ In so far as the bonds that are retired are purchased from the commercial banks, the effect is to reduce the volume of demand deposits. Individual and corporate cash holdings are reduced, since the public is being taxed in order to retire bonds held by the banks. When the process is completed, the public will own less deposits and the banks will own fewer government bonds.

take up the difference of \$3 billion between private investment and private annual savings. In this model, therefore, it is assumed that federal expenditures, including the social-security program, are \$27 billion, with taxes, including payroll taxes, at \$24 billion.

This intermediate level may be regarded as not unreasonable. Moreover, it may confidently be asserted that it is not a situation that need cause any alarm from the standpoint of the fiscal soundness of the government. If the public debt should rise, on the average, by \$3 billion a year, this would mean, assuming a public debt at the end of the war of around \$275 billion, an increase in the debt of slightly over 1 per cent per annum. We can be quite certain that income will rise substantially more than that, probably around 3 per cent per annum, due partly to an increase in the labor force and partly to increasing per worker productivity. As productivity rises, it automatically follows that the real income must be raised proportionately, or more and more unemployment will be created. If we are to solve our unemployment problem and continue to achieve higher and higher levels of productivity we must achieve higher and higher levels of real income. A \$3 billion annual deficit cannot be regarded as resulting in a dangerous ratio of public debt to national income. As we have seen, the debt would rise percentagewise very much less than the expected increase in national income. Thus the ratio of debt to income would, on this model, continuously fall.

The above projected models are not a forecast of what is necessary to achieve economic stability at full employment. The unfolding of events alone can determine the precise magnitudes. Moreover, the magnitudes themselves are not rigid and inflexible, but are subject to modification by wage, price, and tax policies which affect the distribution of income and, therefore, the relative magnitudes of consumption and saving. The figures are suggested as presenting, on the one side, a workable range of flexibility adequate, it is believed, to cope with any probable impending depression or inflationary development, and on the other side at the same time providing a program of financing which would preserve a satisfactory and workable ratio of public debt to the national income.

It should again be emphasized that fiscal policy alone is not adequate. We must seek to achieve sound industrial relations. We must pursue a wage policy which permits mass purchasing power to grow with pro-

ductivity yet which allows industry to cover costs and reasonable profits. We must pursue a price policy which gives consumers the advantages of improving techniques and which avoids the growth of monopolistic profits. And, as a part of fiscal policy, we must adopt a tax program which minimizes restraints on investment and consumption.

The role of state and local budgets under the conditions set forth in our four models are, for illustrative purposes, set down in Table 48.

TABLE 48. State and Local Budgets in the National Economy

(in billions of dollars)

	State and Local Ex- penditures	State and Local Taxes	Federal Grants to States and Localities	New State and Local Issues (largely by public-ser- vice enter- prises) *	Assumed National Income
Model I					
High private investment	\$12.0	\$9.3	\$2.3	\$0.4	\$140
Model II					
Low private investment	15.0	8.9	4.5	1.6	125
Model III					
Feverish private investment	11.5	9.6	1.7	0.2	150
Model IV					
Intermediate level of private investment	13.0	9.2	3.0	0.8	135

* These issues, for convenience (and also because state and local issues bear some resemblance to private issues, particularly the issues of public service enterprises) are included in Table 47 in the category "net private investment."

As already stated in an earlier chapter, state and local governments can make to a limited degree a contribution to a sound cycle policy. Capital expenditures, by the aid of grants and loans from the federal government, can be increased during periods of serious decline in private investment. Normal service expenditures should be stabilized

throughout the cycle with provision for secular growth as population and service standards rise.

State and local tax rates cannot easily be changed during the cycle. To the extent that national income fluctuates, total tax revenues of localities and states will fluctuate some, though proportionately less than income by reason of the relatively stable-yield character of their tax structures. Borrowing, if the recommendations suggested in Chapter X are adopted, could be managed so as to support, in a limited degree, a countercyclical program.

Tables 47 and 48 should be studied together in order to envisage the interplay of the proposed federal, state, and local budgets under varying levels of private-investment activity. The increased federal expenditures, during low levels of private investment, would be made partly on its own functions and partly as grants to the states and localities. While there would doubtless be some moderate increase in welfare expenditures, the main increase in state and local outlays, in order to counter depressional tendencies, would be in the area of public improvement and development projects. This would involve urban redevelopment, public housing, transportation facilities, and exceptional public works.

Chapter Twelve

A REORGANIZED OVER-ALL TAX STRUCTURE

POSTWAR BUDGETS

THE war must inevitably bring about permanent changes in governmental finance. The budgets of the postwar period, as suggested in the preceding chapter, will be of quite a different order of magnitude than those of the thirties.

A consideration of the likely magnitudes of postwar public budgets raises a number of important questions concerning the tax system. Certainly tax rates can and must be reduced below wartime levels. However, it is quite evident that if after the war high income levels can be insured, tax revenues far above the prewar levels can be raised with comparative ease. It is therefore important to consider the magnitudes of private income after taxes which may reasonably be expected in the postwar period.

The table on page 244 compares (a) the Gross National Product, (b) total taxes, (c) the residue available for private saving (gross) and private-consumption expenditures, and (d) income receipts of individuals after taxes, for the years 1929, 1932, 1935, 1938, 1941, 1943, and an estimate for a postwar year.

In order to solve our postwar tax problem, the first concern must be with the magnitude of the national income. If we can maintain a high income level, the tax problem becomes quite manageable. Nevertheless, the fact that large sums will have to be raised through the tax system must condition our thinking about tax changes and tax reductions. It is because our public expenditures will be of such vast importance in the postwar period—in expanding our social services and in maintaining a progressive and stable economy—that it is of primary importance to overhaul thoroughly the tax system, making it at once productive and, as far as possible, nonrestrictive.

Approached from the side of eliminating any possible obstacles to economic expansion, we shall inevitably find ourselves seeking the

TABLE 49. Gross National Product, Income Receipts and Taxes

Year	Gross National Product	Total Taxes	Residual Available for Gross Private Saving and Private Consumption	Income Receipts of Individuals after Taxes *
(in billions of dollars)				
1929	99.4	10.2	89.2	79.5
1932	55.4	8.2	47.2	45.5
1935	70.8	10.6	60.2	56.2
1938	80.6	13.5	67.1	62.8
1941	119.2	24.7	94.5	88.2
1943	187.0	47.0	140.0	124.0
Postwar	160.0	32.0	128.0	119.0

Sources: 1929-41 figures are from the *Survey of Current Business*, May 1942, p. 12, July 1942, p. 23, and August 1943, pp. 12-13. The 1943 estimates are based on "National Product and Income in the First Half of 1943" by George Jaszi in the *Survey of Current Business*, August 1943, pp. 9-14, January 1944, and other sources. The figure for the postwar Gross National Product is based on "Postwar Manpower and Its Capacity to Produce" by S. Morris Livingston in the *Survey of Current Business*, April 1943, pp. 10-16. Postwar taxes are from our Table 11.

* The figures for this column (income receipts of individuals after taxes) are derived by taking the income payments to individuals and deducting personal taxes.

elimination of, or at least drastic reduction in, almost all our taxes. Excises weigh heavily on consumption expenditures, business taxes tend to be shifted to consumption or may discourage capital expansion, high-income surtaxes may discourage investment, and so on down the line. The plain fact is that taxes taken by themselves alone are more or less restrictive in their nature. They can be thought of as being expansionary only in conjunction with the expenditure of the tax funds.

Private investment outlays are powerful prime movers in determining the flow of income. But government expenditures, as explained in Chapter IX, may also play an important role in income creation. Indeed, new government expenditures (as also with private investment) may have a magnified effect on income and employment. It may have a magnified effect if the new expenditure is so financed that an increase in private expenditures is induced. A net increase in private expenditures is likely to be induced if the new government expenditures are continuously financed from loans or from progressive

taxation. Moreover, an increase in useful governmental expenditures (the initial expenditure being financed by borrowing) will tend to raise the national income even though subsequently financed from consumption taxes. Thus, when additional government expenditures are paid out to the public, the income receipts of individuals are increased. If, now, subsequently a consumption tax is imposed equivalent to the enlarged income, it follows that private expenditures after taxes remain as before. The Gross National Product is increased by the amount of the new government spending while private expenditures remain the same. Thus in this case the total Gross National Product (governmental expenditures plus private expenditures) is enlarged roughly by the amount of the new expenditure but not by a magnified amount.

This is true under conditions when the private sector has not already utilized all of the productive resources. In the event of full employment, the addition of new public expenditures would divert resources from the private to the public sphere. Starting from underemployment, however, the net addition of new government expenditures tends to increase employment and to add to the total real income of the community by an amount equal to the value of the public services rendered.¹ But the effect will be magnified if there is an induced net addition to private expenditures over and above the new government expenditure.

The situation is similar to the process of income formation in private

¹ In the case under consideration, it may be assumed that the private sector of the national income and employment is left unchanged and that no change en masse occurs in the marginal propensity of individuals and corporations to save. In this event one may consider that the new income created by the government expenditure (except the initial expenditure which is financed by borrowing) is entirely financed by consumption taxes. Thus, with respect to the new governmental expenditure, the marginal propensity to consume is unity or, in other words, the whole of the new income is spent by the community and none is saved. This sector of the income, therefore, represents the familiar "circular flow" situation in which the whole income that is poured into the income stream is taken again out of the income stream and spent on the production of the services in question. Another way of stating the same thing would be to say that from the standpoint of individuals, the whole of the new income is saved in the form of taxes, and that the marginal propensity to save the additional income is unity since, in fact, the consumption taxes impose the necessity of a saving in the form of taxes equivalent to the new income created by the new expenditures. In these terms, since the marginal propensity to save the new income is unity, the multiplier is one, and therefore the net addition to income is equal to the new government expenditures.

industry. While a new plant is being constructed and no products are being sold on the market as yet, the business pays out income in the form of wages, etc., but does not absorb any part of the national income. After the plant has been constructed, the business continues to pay out wages, etc., for the goods produced, but, at the same time, it gets back an equal amount (including enough to cover all costs and profits) from the income of the community. This case appears to be similar to that of the government increasing the income stream through wages and salaries paid out and later absorbing the same amount in the form of taxes.

From this analysis it follows that the often expressed view that expenditures must be "deficit financed" in order to be "net income creating" needs to be re-examined. The expansionist effect of new government expenditures would tend, however, to be much greater if financed by progressive forms of taxes or from borrowing. This is true because progressive taxes or borrowing are likely to tap, more or less, idle funds or current savings, leaving consumption expenditures unaffected. It is, of course, always assumed that the public expenditures in question are useful and productive and are not of a character that diminish private investment.

If, however, new consumption taxes are imposed while at the same time government expenditures remain as before, the effect is to curtail private consumption and to decrease the total national income.

Consumption taxes have rightly come to be regarded as the most repressive since by definition the funds so taken are abstracted from the consumption stream. Taxation on business is more or less repressive in effect. If business taxes are of a character that add to the cost of production, they are likely to be shifted either (*a*) forward to consumers or (*b*) backward to the employed factors, mainly wage earners. They thus tend to restrict purchasing power, and have an effect somewhat like that of consumption taxes. If business taxes are levied on profits, on the other hand, they may have to a greater or less degree a repressive effect on investment.

With respect to investment, a stiff corporate income tax will tend to deter the introduction of new machinery. Assume that the corporate income tax is 60 per cent. A new machine which, it is estimated, will earn net 20 per cent prior to taxes will yield after taxes only 8 per

cent.² If the corporate tax were only 20 per cent, it would yield (after taxes) 16 per cent. Now it might well be true that the company could not afford, considering the risk of loss, to undertake the new investment unless the reasonable prospect for a net yield after taxes was at least 10 per cent. Under these circumstances, the investment would not be made if the higher corporate income-tax rate were in force, though the deterrent effect would be much less if adequate loss offsets were allowed. On the other hand, the officers of the corporation (unless it is a closely held family concern) are not likely to be deterred from making the new investment if the corporate income-tax rate is low, even though the surtax rates in the individual income tax are very high in the upper brackets.

It is true that a wealthy individual is likely to be deterred from backing a new venture by high surtax rates. But it should not be forgotten that venture capital has typically come throughout our history from funds contributed by middle income-class individuals.³ If the investment opportunity is present, it is probable that more venture capital could be raised from moderate-income groups now than ever before in our history. New businesses are still being developed from small beginnings where opportunity offers a chance for success. It is true, however, that the nature of the modern productive process and the development of large-scale business enterprise limit the opportunity for new concerns, but that is another matter. Moreover, it should also be noted that, under modern conditions, venture capital comes in very large measure from established corporations and businesses.

Nevertheless, it cannot be denied that throughout the length and breadth of the country there are many vigorous businessmen with incomes ranging from say \$25,000 to \$250,000 who are active in the promotion of new ventures. This fairly numerous group (numerically far greater than the few very rich) constitutes an important element in a vigorous and dynamic enterprise system. If these individuals devoted a considerable part of their income in any year to new ventures (frequently joining in with others) the economy as a whole would

² There are reasons to believe that the expected yield after taxes will fall even below 8 per cent if losses cannot be deducted, but the problem is very technical and need not be discussed here.

³ For a survey of the history of venture capital, see Ch. XVIII, in Alvin H. Hansen, *Fiscal Policy and Business Cycles*

benefit. The proportion of all individuals in the income-class range indicated who would play a role as innovators would, however, be relatively small. Yet anyone (in whatever income class) who wished to devote a considerable part of his income to new ventures, and to urban redevelopment and housing projects, might be permitted, when estimating taxable income, to deduct up to say 25 per cent of his net income so invested. A tax abatement on income so invested up to a fixed maximum limit would afford an enormous incentive to undertake useful new investment and at the same time would not seriously affect the progressivity of the tax structure. The encouragement to new enterprise, to urban redevelopment, and housing for the population generally (especially houses valued under \$6,000) would amply justify such a program. Whether a similar tax incentive might be made available to established business concerns is worthy of serious study.

In general, all taxes are more or less restrictive on consumption or on investment. It may, however, be urged that the most repressive are, first, consumption taxes, such as general sales taxes and payroll taxes, and, second, business taxes of a character which increase the unit cost of production. Taxes on business profits are, in contrast with these, far less repressive. Still less repressive are the steeply progressive individual income tax and luxury excises. Least repressive of all, it is generally believed, are estate and inheritance taxes.

Very fundamental for postwar policy is the question whether in the federal income tax, chief reliance should be placed upon the corporate income tax or upon the progressive individual income tax. It is our view that emphasis should be placed upon the latter.

A reduction of tax rates alone will not suffice. The postwar-expenditure magnitudes make imperative the rationalization of fiscal structures and improved intergovernmental co-ordination. With tens of billions in taxes to be raised, governments cannot carelessly tap whatever sources are at hand. Unless the entire tax structure—federal, state, and local—is devised with an eye to economic soundness, the effects on the national economy may be disastrous. The fact that the federal government may have to raise two-thirds or more of all taxes does not diminish the economic importance of state and local tax structures. On the contrary, the very size of the total tax bill must enhance the economic weight of each individual tax.

We can minimize the repressive effect of taxes by (1) a better balance between the various types of taxes, (2) greater equity in the impact of individual taxes (through improved assessment, making the surtax rates more effective by the plugging of loopholes, and similar devices), and (3) the elimination of irrational and irritating features of certain taxes (such as the arbitrary and complex features of state business taxation). Above all, the over-all viewpoint must not be lost sight of, since only by taking into consideration, on the one hand, the expansionary effects of public outlays and, on the other, the impact on the economy of taxes and borrowing can we plan our finances so as to achieve an optimum balance and a maximization of total national income.

Although different tests must often be applied in the public sphere as compared with the private economy, the objective of "getting your money's worth" is pertinent to both. The burden of taxes is one thing when public funds are squandered or are ineffectually used because of poor administration. It is an entirely different thing when the tax money is employed to supply essential social services in an efficient manner, to maintain a high level of national income, and to foster economic and social progress. Thus in weighing the effect of a tax, an essential consideration is the service value provided, together with the effect on the income flow of the expenditure of the tax money.

From the national standpoint, the primary consideration is the real burden of taxes imposed by all levels of government taken collectively. So, too, in considering equity in burdens as between individual taxpayers, the total tax bill must be examined. Each taxpayer is concerned with his total tax liability much more than he is concerned with the relative portions collected by the federal government, his state, county, municipality, and school district. The ideal of equity in tax burdens is not achieved unless the total tax structure, taking the taxes imposed by all governmental units together, is on a progressive basis.

The various levels of government must, by their very nature, have different types of tax structure. Thus, for example, the federal government cannot and should not use the property tax; nor is it feasible for local units to levy a progressive income tax. It follows, therefore, that the relative shares of the total responsibility for financing public

services assumed by the various units of government will determine, in large part, the character of the over-all tax structure, and thus its economic effects.

It is important to note in this connection that, given the federal-state-local tax structure, the assumption by the federal government of a larger share of the total financial responsibility—through aid for the support of services of national interest—would bring with it certain important changes. Because of the greater element of progression in the federal tax system, a shift in financial responsibility would mean a closer approximation to the ideal of taxation according to ability to pay. It would tend, also, to equalize tax burdens as between different regions of the country. The assumption by the federal government of a larger share of the burden of financing social services would ease the fiscal pressure on states and localities. This would permit them to rationalize their tax structures, since they would not be under the same pressure to tap whatever revenue sources are at hand, even though the taxes used are inequitable and economically restrictive in character. Nevertheless, improvements in state and local tax structures will not come automatically, but only as a result of careful study and determined effort. Moreover, a shift of additional financial responsibility to the federal government will make more imperative than ever a thorough overhauling of the federal tax structure.

PRINCIPLES OF A WELL-DESIGNED TAX SYSTEM

Implicit in the discussion in previous chapters of state and local taxes were several criteria of a sound tax system. Before proceeding to a discussion of possible improvements in federal, state, and local tax structures, such criteria are needed as guides. It is significant that the standards are much more widely accepted in theory than in practice. The major problem is one of implementation.

The attributes of a good tax system include: (1) Tax adequacy. (2) Equity in burdens. (3) Simplicity, certainty, and economy in administration and compliance. (4) Economic soundness. (5) Inherent flexibility.

(1) *Tax Adequacy.*—The tax system should provide an adequate yield. Adequacy should be judged, in the first instance, in terms of the over-all fiscal picture—i.e., considering total expenditures and

total revenues of all governmental units, and over a long period of time. Due consideration must be given to the allocation of financial responsibilities among the various levels of government, and to inter-governmental transfers. Account must be taken, also, of all governmental income, nontax as well as tax revenue. Nor can tax adequacy be judged for any one year. Surpluses in good years may be used to make up deficiencies in bad years.

Adequacy should be judged also in terms of the effects of fiscal policy on the tax base. A tax system which undermines the economic base or puts obstacles in the way of economic progress will certainly not be sustaining over any period of time. Without a high level of national income and continued economic expansion tax resources are certain to prove inadequate.

The smaller the unit of government the more important is the element of short-run (year-to-year) stability in tax yield. This follows from the limitations of its tax base and its lack of control over the monetary and credit system. The smaller the unit, also, the less able is it to use the progressive income tax. The opposite holds for the federal government. The federal government can manage effectively widely fluctuating revenue not only because it can administer a comprehensive income-tax system but also because of the breadth of its tax base, and above all by reason of its control over the monetary, banking, and credit system. It follows, therefore, that the smaller the governmental unit, the more stable should its revenue sources be; the larger the unit, the more flexible should be its tax revenues. In the case of the federal government, in fact, a wide fluctuation in tax revenues can serve as an effective balancing factor offsetting fluctuations in the private sector. Federal tax revenues should rise rapidly when business is on the upgrade, and should fall rapidly when depression threatens.

A grant-in-aid from a central to a subordinate government increases the revenue stability of the recipient unit to the extent that the grant is not dependent on the current tax yields of either unit. Thus, an outright grant provides greater stability for the recipient than does a matching grant.

A factor in tax adequacy at the state and local levels is intergovernmental competition for business concerns and for wealthy individuals. Such competition, real or imagined, is important in keeping the rates of certain taxes at low levels in many jurisdictions. The limitations

imposed by this factor can be removed or mitigated by co-operative action in the maintenance of productive rates, or by the use of tax-sharing or crediting devices.

The productivity of individual taxes is also an important element in the adequacy of a tax system.⁴ The breadth and soundness of the tax base and the effectiveness of tax administration are important determinants of productivity. In the case of the income tax, for example, the comprehensiveness of the income concept employed, the level of exemptions, the number of loopholes, and similar factors, are important. The property tax will be productive or not depending, among other things, on: urban redevelopment or further property deterioration; assessment and collection procedures; increase or decrease of property-tax exemptions, etc.

(2) *Equity in Burdens.*—The tax system should be fair. The problem today is not so much one of getting agreement on what constitutes equity in burdens as it is one of applying in practice the generally accepted ideal of fairness. This ideal can be stated as follows: when the benefits provided by the government are *special* and *direct*, the taxes imposed (in cases where the application of a fee is impractical) should be proportional to benefits received. All other taxes paid—which means the great bulk of taxes—should be on the basis of ability to pay—income being usually regarded as the best single measure of ability.

There are certain practical limitations to a 100 per cent application of this ideal. One is the fact that it is impracticable for local units to levy a progressive income tax, and at the same time it is impracticable for the local governments to be completely dependent for their funds on the federal and state governments. Economic considerations may also limit the complete application of the ideal. For example, in a period of inflation, the necessity for reducing purchasing power may be so urgent as to require a heavier burden on lower incomes than could be achieved by a progressive income tax. Within such limits, the tax system—federal, state, and local—should be based on the principles of ability to pay, except in those cases in which the benefit theory can logically be applied.

The ideal of fairness should be extended in its application to include

⁴ Moreover, the yields provided by various taxes are interdependent, raising the rates of one may decrease the revenue produced by another.

equity in tax burdens as between individuals living in various communities and various regions throughout the nation, and also as between various industries and individual businesses. Today, as pointed out in an earlier chapter, the tax load an individual has to carry depends to a considerable extent on where he happens to live; for a business, the tax burden depends on such factors as the number of states in which it is doing business, the number of units through which it carries on its activities, the state in which it is chartered, and whether its profits are of a fluctuating or of a steady character.

The revenue bases employed affect relative burdens as between various groups. Thus, a tax based on sales hits urban taxpayers more than it does farm groups, since the latter use many products that are not purchased in the market. The manner in which the tax base is administered is also of consequence. Thus, classification of property is desirable in that it removes many of the inequities which exist under the uniform taxation of all property. The underassessment of farm incomes for income-tax purposes places a heavier burden on nonfarm groups. On the other hand, the ease of getting at farm property as compared with intangibles may weight the burden the other way.

(3) *Simplicity, Certainty, and Economy in Administration and Compliance.*—The tax system should be simple and economical in administration and in compliance. It should contain a minimum of uncertainties so that individuals and business concerns may know precisely what their tax liabilities are and accordingly may be able to plan ahead.

Complexity and duplication of taxes between governmental units increase uncertainties and enhance the costs both of administration and compliance. Multiplicity, duplication, and uncertainty bring in their wake irritation, tax resistance, and litigation. The situation is especially serious when investment and interstate trade are discouraged.

From the standpoint of minimizing the costs of administration and compliance in the case of most taxes, tax administration by larger units and by higher levels of government is advantageous. Thus, the states are in a better position to collect motor-vehicle registration taxes than are local units. A large county unit can generally administer the property tax more efficiently and more economically than can a

small township. Where centralized tax administration is employed, the techniques available include tax sharing, tax credits, and tax supplements.

(4) *Economic Soundness.*—The tax system should be devised so as to minimize obstacles to economic progress and to maximize economic stability. The mere fact that a given tax may be a good revenue producer is not sufficient. Consideration must always be given to its effect on the functioning of the economy.

Tax barriers to interstate commerce should be avoided. The free flow of interstate trade and the existence of a great nation-wide market are vital for economic expansion. Trade barriers make the transaction of business more costly and less efficient; or they divert the flow of commerce away from its natural channels. The same considerations hold for discriminatory taxes—such as chain-store taxes—which penalize a more efficient way of doing business. A well-designed tax system should avoid placing an undue burden on concerns doing business in many states and localities and thereby putting them at a competitive disadvantage as against intrastate business.

Governments may use the tax device to regulate business or to direct business decisions in the interest of the public welfare. Care should be taken, however, that beyond such deliberate control, maximum freedom be permitted in the making of investment plans and business decisions. The tax system is, after all, a rather blunt instrument of control. Tax laws by their very nature must apply in a general way, treating alike all individuals and businesses within designated broad classes. It is important, therefore, that the greatest possible freedom be permitted for adjustment to individual situations.

The tax system should be geared to a rational fiscal policy aimed at economic expansion and cyclical stability. Thus, it should tap mass purchasing power at a minimum, except when inflationary developments are threatening. A progressive tax structure serves to facilitate a more equitable distribution of income and thereby to develop a high level of consumption. Indeed, from the purely economic standpoint the two leading considerations to be kept in mind in constructing a rational tax structure are (1) to promote countercyclical pressures, including the checking of inflationary tendencies, and (2) to promote

a better distribution of income so that a broad stream of mass purchasing power may sustain high levels of consumption.

(5) *Inherent Flexibility.*—The tax system should be readily adjustable to the changing conditions of a dynamic economy and society. Such flexibility should be inherent in the system itself because of the difficulties as well as the disadvantages of making drastic changes either frequently or rapidly.

In the first instance, our political institutions—especially at the state and local levels—are not geared to making rapid adjustments in fiscal policy and in financial machinery. Important changes in economic conditions sometimes take place within a period of months. Often the changes are erratic and the direction uncertain.⁵ The rapidity of change and the uncertainty of the future make political action difficult. Legislatures meet infrequently; in many of the states, sessions are held for a few months every two years. The political pressures which they face generally have little regard for the immediate economic situation. A long period of time elapses between the voting of taxes and actual collection. These and other conditions make rapid adjustments in taxes difficult, if not impossible.

Moreover, it is important for many reasons that individuals and businesses shall be able to make long-range plans. This is especially true of the investment plans of industry. Sudden or frequent changes in tax rates are certain, in many instances, to work individual hardships and to upset long-standing arrangements to the detriment of the economy.

Because of these considerations, the tax system should have a fairly high degree of flexibility inherent in its very structure. The entire tax structure should be so devised as to meet the major demands of the economy *automatically*. Thus, if income taxes bulk large in the system, there will be an automatic draining off of purchasing power as incomes rise, and a smaller and smaller drain on purchasing power as incomes fall. Also, if the income tax is on a current, pay-as-you-go basis, changes in economic conditions will immediately be reflected in tax collections.

The aim is to evolve a tax system the core of which is by its very nature flexible. So far as the short-run fluctuations in the business cycle

⁵ The economic conditions prevailing in 1937-38 offer a good example.

are concerned, a progressive income tax affords high flexibility even though the tax *rates* remain stable. As a cyclical device, however, we believe that the *normal* rate can advantageously be raised or lowered according to the requirements of economic stability.

THE POSTWAR FEDERAL TAX STRUCTURE

We are concerned in this volume mainly with the problems of state and local finance and the reform of state and local tax structures. Nevertheless, in view of the reallocation of functions on the one side, and the intergovernmental redistribution of public revenues, particularly from the federal level to the state and local levels, brief consideration must be given to the federal tax structure. Unless this is done, it is quite impossible to see the appropriate role of state and local taxation in the national tax picture as a whole.

In intermediate years—years of moderately high private-investment activity requiring some stimulating support from federal fiscal policy—we envisage federal tax revenues, including social-security payroll taxes, of approximately \$23 billion. This sum should be raised from three sources, distributed approximately as follows:

1. Direct taxes on individuals and corporations	\$15 billion
2. Excise taxes, customs duties, and miscellaneous	3 billion
3. Payroll taxes	5 billion
Total	<u>\$23 billion</u>

In fiscal year 1944 with an estimated \$150 billion income payments, it is expected that we will raise from direct taxes (income and estate duties) on individuals \$18.8 billion, of which \$18.2 billion is from the individual income tax. In addition, it is expected that direct taxes on corporations (mainly corporate income and corporate excess-profits taxes) will amount to \$14.0 billion. Direct taxes, individual and corporate, are thus expected to yield about \$33 billion.⁶

Following the war, this total should be reduced to one-half. We should completely eliminate the corporate excess profits tax. (Moreover, the capital-stock tax and the so-called declared value excess-profits tax, both of which yield negligible revenues, should be repealed.)

⁶ *Statement by the President on the Summation of the 1944 Budget*, August 1, 1943, mimeographed

While the excess-profits tax yields enormous revenues (an estimated \$8.7 billion in 1944) and is certainly appropriate and necessary under the special conditions of wartime, it is, under peace conditions, wholly indefensible and inevitably leads to gross business extravagance and inefficiency.

In this book it is not possible to give consideration to the many reforms in federal corporate taxation which are urgently needed. It may be suggested, however, that one reform which would help to promote risk taking would be to allow corporations to carry losses back, say, two years, and forward five years. Unless adequate provision is made for loss offsets, even moderately high rates will deter investment.

Two alternative models for corporate income taxation are here suggested for consideration.⁷

The first model aims to eliminate completely the double-taxation feature which has prevailed in American income-tax procedures in the past. In accordance with past practice, corporate income taxes have been applied to the whole net income of the corporation and, in addition, the stockholder is subsequently taxed under the individual income tax on that part of the corporate income which is distributed in dividends. Under the proposed model, double taxation of the stockholder would be completely eliminated. It is proposed that for any tax deducted at the source, the stockholder shall be allowed a tax credit on his individual income-tax liability.

The tax model proposed above may be described as a tax exclusively on stockholders and not a tax on corporations at all. It is proposed that stockholders, regardless of their income status, pay a 45 per cent individual income tax on that part of their share of corporate income which the corporation chooses to retain; while they pay a tax in accordance

⁷ A third model is worthy of serious consideration but is not here suggested owing to practical difficulties which have not yet been, in our judgment, satisfactorily resolved. Under this model, corporate income taxation would be entirely eliminated and resort would be made exclusively to individual income taxes. The individual would, however, be compelled by some manner (not yet satisfactorily devised) to include as a part of his income a prorata share of the undistributed profits of the corporation. How this may be done in a manner which will not restrict the power of corporations to retain earnings for legitimate and desirable expansion, and, at the same time, provide the stockholder with cash resources from which to pay his share of the tax on the retained income, raises difficult but possibly not insoluble problems. The proposal has much merit and deserves more detailed study.

with their individual income status under the progressive personal income tax on that part of their share of the corporate income which is distributed in dividends. The tax on the retained income would be paid at the source and also the basic ⁸ personal income tax on the distributed part.

The proposed model is essentially similar to the British income tax. The British system eliminates double taxation by applying the normal personal income-tax rate to the undistributed part of the corporate income, while the graduated surtax rates (as well as the normal rate) apply to the distributed part of the corporate income. Our model avoids double taxation by the same method. We were unable to use, however, the normal personal income-tax rate for the undistributed part, since the normal income-tax rate in the United States is very low in comparison with the British—so low in fact that if it were applied to the undistributed part of the corporate income, stockholders whose incomes place them in the middle and high surtax brackets would be unduly favored as compared with owners of unincorporated businesses with similar incomes. In view of this situation, a 45 per cent rate is believed to be reasonable both in terms of an American adaptation to British experience and in terms of equitable treatment of the owners of unincorporated businesses in relation to well-to-do and large stockholders. Admittedly, complete equity could be achieved only by the third model, which, however, presents serious practical difficulties.

The second model is, broadly speaking, in line with past practice. It involves double taxation of the distributed part of the net corporation income. It consists (a) of a corporate income tax on the whole corporate income, and (b) of income tax on individuals on the distributed part of the corporate net income. Under this model it is proposed that the corporate net income-tax rate should be, say, 30 per cent. In addition there would be deducted at the source the basic ⁸ individual income-tax rate for the distributed part of the corporate net income. This additional deduction would, of course, be credited to the individual stockholder in assessing his income-tax liability.

The yield on each of these models depends upon (a) the expected postwar level of corporate net income, (b) the proportion of corporate

⁸ By basic tax we mean the sum of the normal tax and the surtax in the first income bracket if this applies, as under the 1942 law, to all who are subject to an income tax.

net income retained and distributed, and (c) the rates applied. Under the first model, according to our estimates of corporate profits—\$15 billion, as explained below—the corporate part of the tax (that part not credited to stockholders) would yield \$4.0 billion.* The second model would yield corporate income-tax revenues of \$4.5 billion.

In attempting to arrive at a reasonable estimate of postwar corporate net income, one is, of course, dealing in the realm of the greatest uncertainty. Obviously one relevant datum is the size of the national income. The ratio of corporate net income to the national income in earlier years offers some basis for an estimate. It is fair to assume that corporate net profits in high boom years are abnormally high and could not reasonably be expected to be maintained over any long period of time. On the other side, it is reasonable to assume that corporate net profits in seriously depressed years are abnormally low. While far from conclusive, as a first approximation let us consider the ratio of net corporate profits of income-reporting corporations to national income in the period 1922 to 1940, omitting the boom years 1928 and 1929, on the one side, and the depressed years 1930-34 on the other side. The periods chosen are, accordingly, 1922-27 and 1935-40—years more or less intermediate between extreme boom and extreme depression.

For the years selected, the taxable profits of income-reporting corporations averaged \$8,140 million or 11.7 per cent of the national income—12.7 per cent in 1922-27, and 10.8 per cent in 1935-40. In contrast, under the stimulus of the gigantic war program, in 1942 and 1943 taxable profits of corporations reporting net income rose to an estimated average of \$24 billion or 18 per cent of the national income. The profits of all corporations, including those making losses, was, of course, considerably lower.

Such an extraordinary level of profits—so high a ratio to national income—could not be expected under the normal functioning of the price system in peacetime years. Under the operation of the price system it may reasonably be expected that competition, whether perfect or more or less modified by quasi-monopolistic factors, will tend to such an adjustment of costs and prices that profits will occupy

* This amount is net of the tax credit allowed to stockholders on dividends received. The gross amount of the tax would of course be considerably larger than the \$4 billion indicated in the text. Since the stockholders are allowed a tax credit on dividends received, a deduction will be made equal to the estimated tax credit to stockholders.

a normal relation to national income. In areas that are highly monopolistic, it will not infrequently be true that the trade unions will tend to reduce the monopolistic profits by pressure for higher wages. It is therefore reasonable to suppose that the enormous taxable profits of corporations in wartime will fall, under the price and institutional pressures referred to above, to what may be regarded as a normal level as determined by these price and institutional factors under peacetime conditions. Assuming a national income of \$135 billion in the postwar period, a normal level of corporate taxable profits may be roughly put at \$15 billion, giving a ratio to income of 11.1 per cent.¹⁰

Assuming a national income of \$135 billion, Table 50 shows estimated revenues from different tax sources. It will be noted that on the basis of the first corporate income-tax model, the total federal returns from the individual and corporate income tax combined is \$13.6 billion, and from the second tax model \$14.1 billion. Total federal revenues from all sources on these two models range from \$23.0 to \$23.5 billion. Inheritance and gift taxes amount to \$1.2 billion; excises and miscellaneous revenues are \$3.1 billion, and payroll taxes are \$5.1 billion.

Direct taxes on individuals and corporations would be reduced from \$33 billion in fiscal 1944 to \$15.0–\$15.5 billion; excise taxes, customs duties, and miscellaneous revenues from \$5.3 billion to \$2.9 billion.

¹⁰ A correlation analysis of corporate profits and national income—based on data for the years 1922 to 1942 inclusive—would show taxable corporate profits of about \$19 billion with a national income of \$135 billion. We have, however, assumed in our model corporate profits of only \$15 billion. Our assumed \$15 billion of taxable corporate profits is predicated on a stabilized high employment income and not on a peak boom year in a widely fluctuating economy such as we have had in the past. Taxable corporate profits would be one thing in a \$135 billion national income achieved at the peak of a great boom, it would be quite a different thing in a \$135 billion income in an economy stabilized at a full-employment level and not subject to violent fluctuations. As noted in the text, we have taken a ratio of taxable corporate profits to the national income slightly lower than that achieved in moderately good years in the twenties and thirties. We think that the \$15 billion figure can be reasonably defended, though our correlation analysis would indicate that it is possibly on the low side.

It should, of course, be noted that the \$15 billion taxable corporate profits refers to the profits of all corporations reporting net income. It follows that the net corporate profits of all corporations, including those making losses, would be substantially below the \$15 billion figure. Moreover, it should be noted that the \$15 billion includes some double counting since it includes the taxable proportion of intercorporate dividends (15 per cent of the intercorporate dividends).

The payroll tax estimate of \$5.1 billion is based on the assumption of a 7 per cent payroll tax—4 per cent on employers and 3 per cent on employees.¹¹ It is assumed that coverage would be extended and that the social-security program would be enlarged to include not only old age and unemployment but also permanent and temporary disability, and would involve, moreover, a great expansion in public-health services, hospitals, and clinics, in accordance with the provisions in the Wagner social-security bill. The benefits which would be paid out under these proposals would probably exceed the payroll taxes by a relatively small figure at first—but by a greater amount as more bene-

TABLE 50. Total Government Revenues with a National Income of \$135 Billion *

(in billions of dollars)

Tax Sources	Total	Federal	State	Local
Individual income	10.3	9.8	0.5	
Corporate income:				
Plan A	4.6	4.0	0.6	
Plan B	5.1	4.5	0.6	
Death transfer and gift	1.5	1.2	0.3	
Property	4.1			4.1
Alcoholic beverages	1.7	1.3	0.4	
Tobacco	1.0	0.7	0.3	
Gasoline	1.3		0.9	0.4
Motor vehicles	0.6		0.4	0.2
Customs duties	0.5	0.5		
Payroll	5.1	5.1		
Miscellaneous revenues	1.5	0.4	0.5	0.6
Total:				
With Plan A	32.2	23.0	3.9	5.3
With Plan B	32.7	23.5	3.9	5.3

* The estimate of the yield from the federal individual income tax is based on substantial modifications of the 1942 tax schedule. The exemption for a married person is raised from \$1,200 to \$1,600; that for a single individual from \$500 to \$800, and for each dependent from \$350 to \$400. The Victory tax is abolished. The normal tax is retained at 6 per cent. The surtax begins at 8 per cent instead of the present 13 per cent.

The effective *surtax* rate on net incomes after exemptions is considerably reduced below the 1942 rate up to incomes of \$20,000–\$30,000. Beyond \$200,000 the rates approximate the 1942 rates. See, however, the suggestion made on

¹¹ In view of the inclusion of health insurance in the social-security program, it appears reasonable to increase the payroll deduction for employees, leaving the employers' payroll tax, as at present, at 4 per cent.

ficiaries (especially the aged) are added with the passing of time. To the extent that benefit payments exceed payroll taxes the difference, under our proposal, is covered from general revenues. Under the famous Beveridge program in Great Britain, the state would contribute from general revenues approximately one-half of the total cost of social security, which includes, in his proposal, public assistance.

p 248 that lower rates on income invested in new ventures might be justified. A comparison of the federal income taxes paid by a married person with one child at different levels of earned income under the 1942 Revenue Act and under the proposed plan is presented in the following table:

Net Income	Total Taxes Paid under the 1942 Revenue Act Including the Non refundable Part of Victory Tax		Total Taxes Paid under the Proposed Plan	
	Effective Rate		Effective Rate	
\$ 2,000	\$ 113.40	5.7	\$ —	—
3,000	326.40	10.9	122.00	4.1
5,000	795.90	15.9	440.00	8.8
8,000	1,640.90	20.5	1,072.00	13.4
10,000	2,304.90	23.0	1,600.00	16.0
25,000	9,723.90	38.9	8,176.00	32.7
50,000	26,505.92	53.0	24,236.00	48.5

The two corporate income tax plans have been discussed in the text.

The 1942 rate on distilled spirits is lowered from \$6 to \$4 per gallon, while the tax on beer is reduced from \$7 to the pre-1940 rate of \$5 per barrel. Revenues from these two sources usually comprise about 87-88 per cent of all federal revenues from liquor taxes. No changes in state liquor taxes are suggested.

About 90 per cent of all revenues from federal tobacco taxes comes from a tax on (small) cigarettes. The estimate is based on the assumption that the 1942 federal tax of \$3.50 per 1,000 small cigarettes is retained, but that all state tobacco taxes are repealed. To compensate the states for the loss of revenue, it is suggested that the federal government share with the states about one third of the proceeds of the existing federal tobacco taxes, apportioned among the states possibly in accordance with their population, until dependable statistics of the consumption of tobacco products by the several states become available. Due to the small number of manufacturers of tobacco products, the federal tax is collected with remarkable ease. On the other hand, it produces stable revenue and is well adapted to federal state sharing. (For a more thorough discussion of this question see U. S. Treasury Department, *Federal, State and Local Government Fiscal Relations*, 78th Congress, 1st Session, Sen. Doc. 69, pp. 16-17 and 497-510, from which the essence of this suggestion was taken.)

The yields of taxes on gasoline and motor vehicles are based on the assumption that the state taxes be retained at approximately present levels, and that the federal taxes on these commodities be repealed. It is suggested that the states remit about one third of the yield of these taxes to local governments.

Miscellaneous revenues include various fees, special assessments, and other receipts mostly of a nontax character.

IMPROVEMENTS IN THE STATE TAX SYSTEM

If the standards of a well-designed tax system are to be met, the following improvements in the state tax structure are needed: (1) abolition of the general sales tax; (2) greater reliance on personal income and death transfer taxation; and (3) drastic reform of business taxation.

The net effect of these changes would be to give us a state tax structure consisting essentially of the following: (1) personal and corporate income taxes; (2) death duties; (3) gasoline, motor vehicle, tobacco, and liquor taxes.

SALES TAXATION

As was pointed out in a previous section, the heavy reliance on sales taxation by many state governments has evolved, in very large part, in consequence of (a) inadequate yields from other taxes, and (b) the urgent need for revenues during the depression of the thirties in order to meet the costs of the social-security program and the greatly expanded relief burden.

The states cannot be expected to abandon sales taxes unless the productivity of other tax sources can be greatly increased. It is easy enough to suggest the abolition or reduction of sales taxation; it is much more difficult to provide adequate revenues from other sources.

A distinction needs to be drawn between the impact of general sales taxes—including taxes levied on business concerns which by their very nature are readily shifted into prices (such as business taxes on a gross-sales basis)—and that of individual excise taxes. Whereas in the case of the former all items falling within lower-income budgets are directly affected and the consumption of such groups proportionately decreased, in the case of excise taxes, lower-income consumers may escape taxation in part by diverting expenditures to other things or by curtailment of luxury consumption.¹² A gasoline tax, for example, may curtail unnecessary automobile driving without lowering expenditures on food, clothing, and other necessities. The same argument applies to liquor taxes. In the case of cigarette taxes, the element of "luxury" is more questionable; nevertheless, the possibility of substitution to less expensive tobacco products—pipe tobacco, "roll-your-

¹² In fact, it is possible to tax solely items which are of a "luxury" nature.

own," etc.—is not inconsiderable. Thus, it is suggested that as the yields of other and more desirable taxes are increased, abolition or reduction of sales taxes should take place in the following order: (1) general sales taxes, (2) excises on items of wide consumption (tobacco), (3) excises of a semiluxury nature (liquor, gasoline).¹³ How far down the scale we can go will depend on how successful we are in strengthening and broadening the other tax bases.

PERSONAL INCOME TAXES

The view is generally accepted that personal income taxes should provide the largest share of all public revenues. Nevertheless, the question remains whether this tax source should be utilized exclusively by the federal government while the states resort to other tax sources, or whether this source should be shared by the federal and state governments.

In view of the fact that we may expect state expenditures to run around \$4 billion in the postwar period and that sales taxes should be reduced in order to strengthen mass consumption, we are forced to conclude that personal income taxes must provide a fairly substantial part of all state taxes.

At the present time, only 33 of the states levy personal income taxes. Many of the most populous and industrialized states, for instance Illinois, Indiana, Michigan, Ohio, Pennsylvania, and New Jersey, have no personal income taxes. In states with income taxes, the field has been scantily tilled in all but three or four states, owing to factors of interstate competition and to the lack in certain instances of the administrative and legal talent needed to administer a progressive income tax. In the fiscal year 1941, only \$233 million were raised by the states through personal income taxation. The individual income-tax collections of New York State alone have consistently accounted for more than half of the total individual income tax collections of all states. Four states—New York, California, Massachusetts, and Wisconsin—collected 72 per cent of all state individual income-tax revenues in 1941. Although the general unproductiveness of farm income for income-tax purposes is undoubtedly an important factor (as is also

¹³ Special consideration would have to be given to gasoline used for business purposes, including the use of gasoline by farmers

the low per capita income in many states) nevertheless, Wisconsin, about half agricultural and half industrial, and only a median state in per capita income, has demonstrated the potential productivity of the income tax when a broad income base is employed and administration is of a high caliber.

If the personal income tax is to achieve an important role at the state level, a great deal must be done. For one thing, in a number of states, legal, constitutional, and judicial barriers to income taxation will have to be overcome. For example, in Illinois and Washington state courts have repeatedly upset the income-tax enactments of the legislature. In Indiana, fear of nullification has prevented even initial enactment of income taxation. And yet several of the states which now levy income taxes have had to overcome judicial resistance (e.g. Alabama, Minnesota, and Oregon). There is, therefore, no reason to doubt that if concerted action and sufficient pressure were brought to bear, those states which now encounter legal obstacles could overcome them. Another important limiting factor in the development of the state income tax is the prevalent feeling concerning the alleged effects of income taxes on the migration of wealthy individuals. This factor, it would seem, can be overcome only by the achievement of a greater degree of uniformity among the states in the application of the income tax. An approach to such uniformity is suggested at a later point.

One of the most decisive factors limiting the productivity of income taxation at the state level is the narrowness of the tax base. While no income-tax statute in the United States grants a specific exemption to farmers on the consumption of home produced commodities, ineffective administration of the statutes practically has this effect.¹⁴ Wisconsin, however, includes a presumptive food income of \$90 for each adult and \$60 for each minor living on a farm. None of the states tax the rental value of an owner-occupied home as a part of income. It is well worth noting that Great Britain has taxed both food consumed by the farmers and imputed rent for a great many years, and with great success. Certainly, if the income-tax base is to achieve its proper breadth, an effort must be made to include these items in the base.

Whereas formerly many of the states had exemptions lower than the federal income-tax exemptions, now only two states have exemp-

¹⁴ U. S. Treasury Department, *op cit*, p. 423.

tions as low as the 1942 federal level (\$500 and \$1,200). In fact, three states grant exemptions for single persons of \$1,500 and one state an exemption of \$2,000.

The community-property provision in eight states lightens both the federal and state income-tax burden below the effective rate generally indicated. Moreover, as is true also at the federal level, a number of fairly important loopholes are found in the state income-tax laws and in administration. All personal income-tax states now exempt the interest from federal securities. Whereas all tax the income from obligations of other states, only nine tax income from the obligations of the home state, while twelve tax the interest from the obligations of the political subdivisions of the home state. Interest from all government securities should be included in the income-tax base.¹⁵

The question of the possibility of increasing state income-tax rates encounters the problem of excessive burdens on the taxpayer and the possibility of a confiscatory or near-confiscatory combined federal and state income-tax rate. At the present time, state taxes are deductible in computing the base of the federal tax. Twenty-two of the thirty-four states imposing individual net income taxes grant an unlimited federal tax deduction. Three others limit it, and the remaining nine deny it completely. An increase in state tax rates would clearly require the extension of deductibility to the states which now do not grant it. Mutual deductibility is an effective remedy against confiscatory double taxation of incomes by the federal and state governments. Thus, for example, a federal marginal income-tax rate of 80 per cent, together with a state income-tax rate of 15 per cent, with reciprocal deductibility, would result in an effective total marginal tax rate of 80.7 per cent, with the federal effective rate 77.3 per cent and the state effective rate 3.4 per cent.¹⁶

If personal income taxation is to play an important role at the state

¹⁵ All state individual income-tax structures are graduated, but the rates are, typically, relatively low. The highest state rate is 15 per cent, applicable to taxable incomes of \$15,000 and over in North Dakota and \$250,000 in California. In 26 states, including New York and Massachusetts, the maximum rate is 7 per cent or less, of these, in turn, the maximum rate of eight states is below 5 per cent. Cf. Roy G. Blakey and Violet Johnson, *State Income Taxes*, p. 35.

¹⁶ "Because of the deductibility feature of federal and state income tax laws the federal government can and should feel free to order its wartime and postwar income tax schedules without much regard to the present state levies or possible changes in the latter." *Ibid.*, p. 13.

level, two things are indispensable: (1) an improvement in state income-tax administration, including some solution of the problem of interstate competition, and (2) the achievement of a high degree of co-ordination in the income-tax field between the federal government and the states. The accomplishment of these is far from an easy matter, and past experience would indicate that nothing short of a fairly drastic departure from present practices will suffice.

A number of mechanisms have been suggested at various times, including the separation of sources, a tax credit, tax sharing, and state supplements to the federal tax. Each of these solutions has its advantages and disadvantages. The one, in our judgment, which offers the maximum advantage, and is also the most feasible, is the device of state supplements to the federal income tax. This would achieve single administration of the personal income tax and uniformity of application.

In essence, the plan is as follows. Each state would inform the federal government what rates it is to collect from its citizens, and the federal government would collect the state tax as well as its own. This would require a uniform definition of "net taxable income." Since the basic concept of "income" is essentially the same all over the country, this would not involve any abridgment of the freedom of the states. In practice, the taxpayer would start with a uniformly determined net income figure, to which he would apply the personal exemption and rates enacted by the state of jurisdiction. The calculations would be performed on a joint federal-state return. Clear-cut definition of the jurisdiction to tax (in terms of domicile) would be required.

Such an arrangement of state supplements to the federal income tax would give the states complete independence as to the level and type of personal exemption and the rates to be applied. Thus, the tax rates could be adjusted to suit the revenue needs of each state.

The device of state supplements to the federal individual income tax described above would have a number of important advantages: (1) It would reduce the costs of administration and compliance. (2) It would permit the use of the income tax by those states which at the present time do not possess the machinery and personnel required to administer such a tax efficiently. (3) It would enable many of the states to assess more adequately income in kind and farm income generally and to close certain of the loopholes now existing. (4) It

would undoubtedly encourage a greater uniformity in rates among the states, and by the application of reciprocal federal-state tax deductibility, the factor of interstate competition would be reduced to minimum proportions. (5) It would greatly reduce multiple taxation and tax confusion since this method would require a clear-cut interpretation with respect to tax jurisdiction. (6) It would permit a better co-ordination of personal income taxation and taxation of corporations.

We believe that a concerted effort in the direction suggested would permit the states to rely much more heavily on income taxation and to that extent reduce their regressive and repressive sales taxes.

DEATH AND GIFT TAXES

Death transfer taxation in the United States represents some special problems because of its threefold character (estate, gift, and inheritance) and because it is used both by the states and the federal government. At present, the federal government imposes an estate tax with progressive rates ranging from 3 per cent on the first \$5,000 of the net estate after all exemptions to 77 per cent on the remainder above \$10 million. A flat exemption of \$60,000 is provided on all estates. In addition, bequests to charitable, religious, and similar organizations are fully deductible from the gross estate.

The federal government also imposes a gift tax at a rate equal to three-fourths of the estate-tax schedule. The gift tax is levied on a cumulative amount of gifts made by the donor during his lifetime. The donor is allowed a flat \$30,000 exemption; in addition, gifts up to \$3,000 per year *per donee* are also exempt from taxation. Contributions to charitable and similar organizations are free from taxes.

There are two major defects in federal estate taxation: first, there is no co-ordination between estate and gift taxes; second, both taxes suffer from excessively high exemptions. Because both estate and gift taxes are progressive and carry separate exemptions, a foresighted individual can reduce his tax liability to a minimum by giving away a part of his property during his lifetime and bequeathing the rest. Property transferred in "contemplation of death" does not escape estate taxation, but the practical application of this provision is often beset with considerable difficulties. In this manner he can take advantage of all exemptions and of the tax rates applicable to the lower brackets in

both estate- and gift-tax structures. Only the person who failed to make such provisions or died unexpectedly would subject his property to the full weight of the estate tax. The wisdom of inserting comparatively high estate taxes in the statute and at the same time providing perfectly legal avenues of avoidance is highly questionable, to say the least. The public is thus given an entirely misleading impression as to what the federal tax structure really is. In addition, inadequate gift taxation makes personal income taxes less progressive and productive because by transferring parts of his property to his relatives or others, a person can considerably reduce his current income taxes. Thus the Treasury loses revenues on several accounts.

The link between federal and state death taxes consists of a provision in the federal law that death taxes paid to a state or states can be offset against federal estate-tax liability up to 80 per cent of that liability which would exist if the 1926 federal tax rates were still in effect. This arrangement was made in 1926 in order to settle the problem of federal-state competition in the field of death taxes and also to bring more uniformity in the state laws themselves. Actually, neither objective was satisfactorily achieved. Most of the states have passed laws to take advantage of the federal credit. But the actual methods chosen by them differ considerably. A majority of the states impose an inheritance tax, and in addition an estate tax¹⁷ equal to the difference between the inheritance taxes collected from a given estate and the federal credit. Some states collect a larger amount than the federal credit. Only 12 states have gift taxes.

Under the Federal Revenue Act of 1926, estate taxes were comparatively light, with a flat exemption of \$100,000. Since then, the rates have been raised several times, particularly in the middle brackets, and the exemption lowered to \$60,000. But, as was already mentioned, the credit given to the states applies only to the 1926 tax rates. Therefore, the states get a larger share of taxes on very large estates, and a smaller share on the smaller ones. As there are comparatively few very large estates, an unnecessary instability in state revenues is introduced. In addition, the tax credit does not apply to the federal gift tax, in-

¹⁷ An estate tax is imposed on the estate as a unit. An inheritance tax is levied on the shares received by the heirs, and usually has lower rates for the members of the immediate family of the decedent.

augurated in 1932. Since the federal law actually encourages the transfer of property by gifts, rather than by bequest, the states lose a part of the revenues to which they would otherwise be entitled.

It is generally recognized that death taxes are good taxes. The right of transferring property after one's death is specifically given by the state. Death taxes permit a more equal distribution of wealth, and they are not likely to have detrimental effects on investment. Finally, they can be well justified from the point of view of ability to pay. There is every reason, therefore, why greater use should be made of them.¹⁸

The reform of federal death taxes should begin with a complete integration of the estate and gift taxes. When an estate is left, the base to be taxed should be determined by adding to the value of the estate all gifts made by the decedent during his lifetime. The tax will then be determined by applying the appropriate rate, from which sum all gift taxes already paid would be deducted. The annual exemption of \$3,000 per donee might well be lowered to, perhaps, \$2,000. The total exemption available at present of \$90,000 (\$60,000 under the federal estate tax, and \$30,000 under the gift tax) is certainly too high, and could well be reduced to perhaps \$10,000.¹⁹ The tax rates might well be raised.

Such reforms should be accompanied by improved co-ordination of

¹⁸ Strictly speaking, the federal estate tax does not fully correspond to the principle of ability to pay. It is imposed on the estate as a whole, without regard for the shares of the several heirs, nor for their general economic position. It is sometimes suggested that an ideal death tax would be of the inheritance type and its rates would depend on the heir's total wealth and / or income. (It may be worth while to remark in this connection that whatever form the death tax takes, it reduces the magnitude of the inheritance going to several heirs.) To be entirely successful, it would have to be accompanied by a cumulative gift tax not on the donor, but on the donees. There is no doubt that this suggestion contains considerable merit and is certainly worth further study. For a more thorough discussion of this problem see Henry C. Simons, *Personal Income Taxation* (Chicago, 1938). His proposal would lead to a thoroughgoing reform not only of our gift and estate taxation, but of the general personal income taxation as well. As it would involve a complete departure from the death tax principles adhered to in this country, extremely difficult administrative problems would have to be solved before its application would be feasible. For the time being, it is more practical to proceed on the assumption that existing principles of federal estate taxation will be retained, even though at the expense of some equity.

¹⁹ It is interesting to note that in Great Britain the flat exemption equals only £100—about \$400.

the federal and state death-transfer taxes. The simplest method of co-ordinating federal and state gift and estate taxes would be to adopt a tax-sharing plan. The federal government would collect the tax in full, and then remit a stipulated percentage to the state or states concerned. Considerable economy of collection would thus be achieved, together with complete uniformity of estate and gift taxation among the several states. But such a system would require the surrender by the states of their freedom of taxation in the death- and gift-tax fields. The political difficulties involved are quite evident. It seems better, therefore, to continue the present crediting device with which the states are already familiar, and which gives a greater scope for adjustment to the revenue needs of particular states.

It is hardly necessary to argue that this credit should be applied not to the obsolete 1926 rates, but to the *current* federal schedule of the integrated estate and gift tax. The exact percentage of credit to be established will depend on the actual federal rates then in existence. It should be high enough to assure that the vast majority if not all of the states will suffer no diminution in revenues. It may also be desirable to allow the states a higher percentage credit on smaller estates, and a lower percentage on larger ones, in order to achieve a greater degree of stability in state revenues.

With the federal credit available, the states would remain free to impose any estate, inheritance, and gift taxes they choose. There will be no danger that the rates may be unduly low due to interstate competition for wealthy residents, because it will be in the interest of each state to apply sufficiently high taxes to absorb at least the federal credit. If a state does not intend to collect larger revenues than allowed by the federal credit, it can use the simple device of passing a statute providing for the exact absorption of the federal credit.

Closer co-ordination between federal and state taxation would also improve existing administrative procedures. At present, an executor of an estate has to deal with federal and state (and often more than one state) authorities separately. The evaluation of the estate is also done separately. It would be a great improvement if the evaluation of the estate were done by the federal government alone. The federal government would thereupon release the relevant information to the state or states concerned. A designated federal agency could act as an umpire in the frequent disputes among the states in regard to the

domicile of the decedent and the estate. This would help to eliminate multiple taxation of estates and prevent much litigation.²⁰

BUSINESS TAXATION

Business taxation at the state level is characterized by confusion and arbitrariness, and is of an economically restrictive nature. State taxes on corporations as such, in addition to net income taxes, include incorporation fees, and taxes imposed upon foreign business as a condition of doing business in the state, property taxes applied to the value of intangibles held and represented by the corporation, and capital-stock taxes. In some states, a variety of special charges are imposed upon business, most of which are based upon no reasonable principle whatever. Unincorporated business is subject to special net income or other special taxes in several states, in addition to many of the occupation taxes.²¹

One of the most important problems in the entire tax field is clearly that of minimizing the repressive effects on both consumption and investment of the various taxes. Many suggestions have been forthcoming involving the abolition of various taxes in order to prevent the dampening of the investment incentive. Positive investment inducements have been suggested in order to achieve an expansionary economy in the postwar period. Although the wholesale reduction of taxes on business or the total abolition of certain of these taxes would undoubtedly have expansionary effects in many instances, we are faced as a practical matter—as was pointed out in an earlier chapter—with the problem of raising revenues adequate to maintain the necessary social services and to permit the constant flow of public expenditures in the proper directions. The question might well be raised, then, as to whether the most serious repressive effects of business taxes might not be minimized by rationalizing the whole business-tax structure rather than by a wholesale elimination of the business-tax base. This is not to say that a certain “de-rating” of business taxation might not be desirable; rather it emphasizes the tremendous economic advantages which can be derived from the substitution of a rational system for the present chaotic and arbitrary business taxes. Such a sub-

²⁰ Judicial review of the decisions of the arbitrating agency should be provided

²¹ U. S. Treasury Department, *op. cit.*, pp. 454-457

stitution would, we believe, go a long way toward reducing the restrictive effects on the economy which would otherwise prevail.

Nothing short of a complete reorganization of the business-tax structure of the states will suffice. The present restrictive burden on interstate concerns must be removed and the more efficient methods of doing business encouraged instead of discouraged. The jurisdictional conflicts and the diversity in the apportionment of corporate income in the taxing of concerns now place an undue burden on cosmopolitan business. Moreover, the present costs on business concerns of complying with the wild conglomeration of tax laws must be greatly reduced and the costs of business-tax administration lowered. The unhealthy competition for business concerns which prevails among the states must be brought within reasonable limits. The present confusion and uncertainty in the business-tax field must be removed so that business enterprises may be able to plan more securely.

The first prerequisite in the rationalization of business taxes is the simplification of the business-tax structure. This is important from the standpoint of removing a serious irritant to business; of reducing the extremely high costs of compliance; and of removing a number of arbitrary and variable factors which make the calculation of business costs and the preparation of investment and other plans extremely difficult. This would suggest the desirability of substituting a single productive business tax for the present conglomeration of taxes. The choice of such a single business tax is important.

There is considerable support for the utilization of taxes on broad bases which would reach all businesses whether operating at a profit or a loss. Taxes based upon gross income, value added, or capital stock are of this nature. Many of the states, as a matter of fact, do employ taxes of this type. A good case can undoubtedly be made for the payment of some taxes by all businesses, in addition to property taxes, for the benefits received from government. However, it must be clear that the incidence of business taxes based on other factors than net income will tend in most instances to be treated as business costs and shifted forward to consumers or back to the factors of production. Thus, the use of such taxes involves, in the main, a burden on consumption. The substitution of a tax of this nature for currently employed taxes would not involve any gain from the standpoint of freeing the flow of income into consumers' expenditures in the postwar

period. Moreover, business taxes based on other than net income—to the extent that they cannot be readily shifted—impose an onerous burden on business concerns that are hard hit by a depression, and may, in fact, prevent them from weathering the temporary storm. Except for licenses and franchise taxes—legitimate special charges on business concerns for special privileges conferred—the corporate net income tax should be made the sole business tax.

Whether the corporate net income tax is employed solely or in combination with other business taxes, it is important that the apportionment of corporate income of interstate concerns among the states in which they do business be rationalized. It is highly desirable that all the states adopt a single formula for the allocation of corporate income. The formula which is now most widely employed is the so-called Massachusetts formula which accords equal weight to three factors, tangible property, payroll, and sales. It has been satisfactorily tested and its legality upheld. Moreover, its factors are easily ascertainable, involving no allocation of overhead costs. The adoption of a single formula by all states employing the corporate net income tax would overcome the present confusion and the undue burden of concerns doing business in many states. Such an arrangement would permit each corporation to allocate its income among all the states on the basis of the allocation fractions. It would be extremely helpful, also, if some mechanism—in the form of an impartial umpire—was set up for settling jurisdictional and other problems which inevitably arise.

The objective for the immediate future should be the rationalization of the business-tax structure within each state. A thoroughgoing reform would involve, as indicated above, the adoption of the corporate net income tax as basically the sole method of taxing business concerns, and the use of the Massachusetts formula to determine the state share. If this were done the costs of collection and compliance would be greatly reduced, business enterprises would be able to estimate cost more accurately and to plan more securely, and the burden on private enterprise during periods of financial distress would be greatly lessened.

IMPROVEMENTS IN LOCAL FINANCES

Local governments, in general, are in a rather untenable position. On the one hand, they are under constant pressure to expand social

services, and are saddled with new responsibilities and mandatory expenditures by state and federal action. On the other hand, their tax powers are extremely limited. They can exercise only those tax powers which have been granted to them by the states. Moreover, they suffer from tax conflicts. With federal, state, and local governments vying for sources of revenue, the local governments come off third best. The sources left to them have been circumscribed by state legislation and by adverse economic developments.

If service standards are to be raised, if facilities for education, health, welfare, recreation, housing, transportation, etc., are to be improved, a better balance between local service responsibilities and local financial resources must be achieved. The Municipal Finance Officers' Association put it well when it stated in a special report: "This is not a question of budget balancing, of making outgo equal income. Instead it is a problem of maintaining a standard of governmental services which is necessary for the welfare of the people."²² Income and outgo could, of course, be balanced by curtailing expenditures, but this would surely be a defeatist solution, and one which would fail to provide community and social-welfare services which modern living standards require and which are commensurate with the productivity, income, and wealth of the United States.

At present, local governments are supported largely from ad valorem property-tax receipts, which, in recent years, have amounted to approximately \$4.5 billion. The bulk of this revenue is derived from taxes on real estate.²³

The local property tax is a much abused instrument. In periods of stress and financial embarrassment, especially, the property tax is much criticized, and drastic proposals—extending to the complete abolition of the tax—are forthcoming.

Any tax, no matter how sound it may be basically, and no matter how effectively it is administered, will bog down when it has too heavy a load to bear. The great bulk of localities have depended almost entirely upon the property tax for their revenue sources, and the tax

²² Municipal Finance Officers' Association, *The Support of Local Government Activities* (Chicago, January 1939), p. 2.

²³ According to census data, real property represented 85.1 per cent of total assessed valuation for 1940 in cities over 100,000 population, while 86.5 per cent of all property taxes levied was imposed on real estate. U. S. Bureau of the Census, *Property Taxation 1941* (September 1942), pp. 39-40.

has, therefore, had to bear almost the entire burden of the expanding municipal services and responsibilities. Probably the greatest contribution that can be made toward the improvement of the property tax is to relieve it of some of the excessive burden which it has had to bear. The absorption by the federal and state governments of a larger share of the ever-growing financial responsibilities of local communities would be an important step in that direction. Under our proposal property taxes would still remain an important revenue source, but in proportion (a) to national and (b) to total tax revenues very much smaller than heretofore.

Part of the difficulties which many urban governments face today arises from the failure to adjust to the economic and social developments of recent decades. The process of suburban development has wrought havoc with the tax revenues of the central cities. Greater federal and state aid would in large measure have the effect of compelling all those who share in the benefits conferred by government within an urban area to bear a fair share of the costs.

The decline in property values, which has imposed such serious financial problems upon local communities in recent years, is treated by some as if it were a "natural" development completely outside of human control. There is nothing essentially mysterious about property values. They are functions of such factors as the rate of urban growth, the degree of decentralization within the urban area, the deterioration of physical structures, maladjustments in land use, and the level of economic activity within the region and within the nation. Most of these factors can be managed through proper organization and control.

Wise land-use planning and redevelopment programs can reverse the downward trend of property values in many areas of the country. When we consider the wartime demonstration of our national productive capacity, it is ridiculous to assume that property values must continue to decline. Given the courage to undertake boldly conceived and well-executed development and redevelopment programs, real estate can be made a stable and productive tax base.

Legal and administrative handicaps often limit the productiveness of the property tax. These include inflexible tax-rate limits, too liberal tax-exemption policies, inefficient assessing methods, and restrictive rules of tax jurisdiction.

In many instances, states have imposed upon their localities rigid

limitations of tax rates which have placed such communities in financial strait jackets.²⁴ A New York State Commission which studied the effects of a tax limitation law upon local governments presented the following summary of reasons for the unsoundness of over-all tax limitation:

1. It destroys the fundamental right upon which local self government is based through preventing citizens of a locality from determining the governmental services they want and are willing to pay for.
2. It puts local government into a strait jacket which stifles its development and must in the end result in its disappearance.
3. It makes no attempt to eliminate the *causes* of the high cost of government but endeavors to solve a complicated problem by a simple application upon the effect. It would be as intelligent to endeavor to cure the measles by applying ointment to the spots
4. In New York State where many units of government may overlap in a given area, any form of over-all tax limitation is completely impracticable of application unless the aim be to destroy such units of government with little or no consideration as to which units should be abolished and which preserved.
5. Like the fable of old in which the man was made to fit the bed instead of the bed being made to fit the man, over-all tax limitation endeavors to apply a uniform remedy to situations which are not uniform. The needs of communities vary almost as much as their capacity to pay for services of government. . . .²⁵

Although in very many instances real estate taxpayers have legitimate grievances, the over-all tax limit is a very poor mechanism for accomplishing the desired results. The state could accomplish more by devising a rational system of grants-in-aid and by employing administrative controls of local budgeting and fiscal management. The device of state administrative assistance and control has proved its usefulness in North Carolina, New Jersey, and elsewhere.

There has been a tendency, also, to exempt from the property tax an ever-increasing number of property classes, especially homesteads.²⁶

²⁴ A. M. Hillhouse and R. B. Welch, *Tax Limits Appraised*, Public Administration Service No. 55 (Chicago, 1937).

²⁵ New York State Commission for the Revision of the Tax Laws, *The Effect of a Two Per Cent Limitation Law upon Local Government in New York State*, Legislative Document No. 54 (1936), p. 353.

²⁶ See Carl H. Chatters, "To Strengthen Municipal Finance," *National Municipal Review*, Vol. 31 (July 1942).

The proportion of tax-exempt property (reported by the Census Bureau as 22 per cent of all real property in 52 cities of over 100,000 population in 1936) is increased by federal wartime acquisition and construction. The exemption of certain classes of property from the real-estate tax in order to carry out certain social policies—such as the encouragement of home ownership—is a clumsy and often self-defeating mechanism. Exemptions tend to spiral upward in a vicious circle, and once granted are difficult, if not impossible, to remove. It must be clear that tax exemption is, in essence, a subsidy. In many instances it would be preferable to employ an outright subsidy. The subsidy would be visible to everyone and the necessity for granting the subsidy could be re-examined periodically in preparing a public budget. Moreover, in most instances, an outright subsidy would be more effective in bringing about the results desired.

In acquiring property within local communities, the federal government must recognize its responsibilities for avoiding the disruption of municipal finances. There is need for developing a regularized system of payments-in-lieu-of taxes instead of the present makeshift arrangements.

The productiveness and fairness of the property tax depend to a very large extent on its administration. Undoubtedly a great deal can be accomplished by improved valuation and collection techniques and improved property-tax administration in general. Many of the small local units cannot afford to employ full-time trained personnel. In such cases it is highly-desirable that property-tax administration be transferred to a larger unit, such as a metropolitan or county government, and in some instances the possibility of centralized state administration might well be examined. Modernized techniques for sound property-tax administration are known, but in most cases have yet to be applied. These include improved techniques for valuation and assessment, vigorous tax-collection methods, provisions for periodic payments, and simplification of tax-lien procedures.

Of great importance is the integration of the acquisition, use, and disposition of tax-reverted properties with master planning and land-use control. Tax enforcement is generally lax because of the hesitancy on the part of local officials to resort to tax foreclosure. In the absence of master planning and urban redevelopment programs, tax administrators hesitate to acquire tax-delinquent properties. They prefer to

retain as many properties as possible on the tax rolls, even where continued delinquencies would appear inevitable because of the improper use of the land or its general unproductiveness. With the establishment of definite land-use programs, we can look forward to important improvements in tax enforcement. This would help to break the vicious circle in which many localities now find themselves. Because of delinquencies, the burden on taxpaying properties becomes progressively heavier. The pyramiding of burdens upon the taxpaying land drives successively the less able taxpayers into delinquency. Thus the effective tax base shrinks more and more.

A major reform in property taxation which is long overdue is the substitution of a classified property tax for the general uniform system now employed in most areas. The process of property classification for tax purposes has already begun, but it remains to be further rationalized and extended to those communities which do not as yet employ the classification technique.

Simeon E. Leland has presented the desirability of employing the classification principle on three grounds.²⁷ In terms of equity, he emphasizes the economic differences among various classes of property, differences which are predicated on earning power and, therefore, ability to pay. Under the heading of expediency, he cites experiences under the general property tax to show the futility of applying uniform methods and uniformly high rates in the taxation of dissimilar types of property. Finally, on the basis of sociopolitical consideration, he indicates the advantages of a classification system which would make it possible to increase or decrease the tax burdens of designated types of property for specific social goals.

Edwin H. Spengler has suggested that—

While different forms of tangible and intangible personalty have been classified in great detail and real estate has been differentiated into timber, mining, agricultural and town plots, little progress has been made thus far in the extension of the idea of classification to urban land use. In the direction of progressive urban planning and local tax reform, sound principles of land use classification should be developed so that social aims and tax policy might go hand in hand. This would go far toward the elimination of unwise "hit-or-miss" methods of granting subsidies through tax exemption, and

²⁷ Simeon E. Leland, *The Classified Property Tax in the United States*, Ch. 5 (Houghton Mifflin Co., New York, 1928)

substitute therefor a carefully worked out plan of graduated burdens based upon economic and social considerations.

The extension of the principle of property classification to urban land provides us with a workable basis for the distribution of some of the local tax burdens. Instead of assuming that all property within a city is homogeneous and that it should be taxed at a flat percentage of its dollar valuation, it is proposed that urban properties be carefully classified according to use and taxed at differing rates determined for each class of land use. Thus, residential land would be taxed at one rate, commercial and business properties at another, and industrial parcels at still a different rate. Residential land, in turn, might be classified into one family, two-family, and multiple-dwelling types, with further subclassifications within each of these groups (e.g., attached or semidetached one-story dwelling, two-story-detached, etc.)—all taxable at slightly different rates. Similarly, special rates would be determined for stores, offices, lofts, warehouses, and other classes of commercial and industrial properties.²⁸

Property taxation in rural areas is not infrequently characterized by poor assessment and collection procedures, resulting in unequal and sometimes exorbitant burdens on the land least able to pay taxes. Studies in various states reveal that overvaluation of poor land for property tax purposes is fairly common. Overassessment leads to overtaxing which in turn leads to cumulative delinquency. The classification basis for assessment purposes is often inadequate. All land level enough for farming, for example, is sometimes classed as farm land regardless of such factors as rainfall dependability and soil fertility. In large areas of the Great Plains the overvaluation of range lands is frequent and derives from a classification system which dates from the period of the first World War when high prices for wheat prevailed and such lands possessed real productive value.²⁹

An improved classification system, such as that utilized in North Dakota, would consider such factors as the productivity of the land according to different land uses under current systems of management,

²⁸ Edwin H. Spengler, *Urban Taxation*, unpublished memorandum, mimeographed (Washington, 1943), pp. 22-23.

²⁹ In one Colorado county, for example, no change in classification of land for assessment was made between 1917 and 1939. Current grazing survey data indicate that of a total of 236 sections, only 17 are classified properly, 21 sections are underassessed, and 138 sections are overassessed. See S. W. Voelker and T. W. Longmore, *Assessment of Dry-Farming and Grazing Land in Weld County, Colorado*, U. S. Department of Agriculture, Bureau of Agricultural Economics (Lincoln, Nebraska, July 1939).

accessibility of markets, availability of water, and size of area, to form the basis for an assessment in conformity with the income possibilities of the land.³⁰

Rural property-tax administration, as a general rule, tends to be slow in making adjustments to important economic changes. Assessments tend to remain high long after property values and product prices have fallen. Any attempt to maintain revenue yields by continuing prosperity-level assessments is doomed to failure and must in the end prove to be self-defeating. Since property taxes constitute a major cost item in the agricultural sector of the economy, it is important that assessments be revised promptly following downward value changes in order that deflationary pressures may be lessened. Assessment procedures are needed also to permit prompt reassessment of properties favorably affected by economic expansion and by an increase in product prices.

The ability to make equitable assessments and reassessments in keeping with changing economic conditions, as well as the ability to make prompt collections and to manage the problem of tax delinquency, will depend on the efficiency of the tax administration. Effective administration cannot be expected when officials are untrained and poorly paid. Local-government reorganization in rural districts is needed, as we have already noted, because full-time qualified assessors and finance officers can be supported only by large units.

Long-range programs of land-use adjustment are needed particularly in the "problem" areas of the country. Generally these areas are those in which there is a conflict between extensive and intensive land uses, the chief common characteristic being unsuccessful efforts to maintain intensive use under conditions of soil, climate, location, and types of settlement which are primarily suited only to extensive utilization. It is in these areas of chronic land-use maladjustment that public holdings of tax-reverted lands can be made a useful instrument for the development of sound programs of land use. In this connection, the progressive program which has been adopted by Arkansas is worthy of note. Formerly, tax-reverted state lands were sold at a flat rate of a dollar per acre. Now, no land is sold except at its appraised true value. Moreover, no land is sold for farming purposes except in tracts large enough

³⁰ National Resources Planning Board, *Land Classification in the United States* (Washington, 1941), pp. 142-143.

and of the quality and location to support farm operation. Homesteads are open only to applicants who show capacity to become successful farmers. Efforts are directed at prying farmers away from one-crop systems. In harmony with a long-range developmental plan, lands unsuited for agriculture are developed as public parks and forests, picnic grounds, recreation areas, and similar land uses.³¹

In areas of the so-called rural-urban fringe, programs of intelligent land-use planning are likewise required. In such areas "the speculative urge to convert lands suited by location and inherent qualities only for rural uses, into plots adapted in shape and size only for urban uses, is responsible for a large share of the economic dislocations which have taken place."³²

Premature subdivision of rural lands into city lots takes place even when large tracts of vacant land are already present within the urbanized area. Such hedgehopping developments typically involve unfortunate consequences for property values and incur excessive municipal costs.

As a general principle, land assessments within the farm urban fringe should be retained at a level consistent with its farming uses, rather than at a speculative value in anticipation of urban expansion. Otherwise vacancy and nonuse lead to delinquency. The legal status of delinquent fringe land should be cleared up, and a simple and inexpensive procedure for the public assumption of title should be evolved.³³

Although most of the states have relinquished the use of the property tax, a number of states still pile a property levy on top of the local rates. In view of the importance of the property tax in local revenue systems and the relatively broader tax resources of the state, it is logical that the property tax should be used as a revenue source exclusively by local government. One advantage, however, can be claimed

³¹ Hugo C. Schwartz, "Tax Delinquent Lands in a Land Use Program," *Proceedings of the National Tax Association*, 1941, pp. 610-612.

³² Philip H. Cormick, *Premature Subdivision and Its Consequences*, N.Y. State Planning Council (Institute of Public Administration, 1938), p. 326.

³³ The relationship of vacancy to delinquency in the rural urban fringe is illustrated by the experience in four townships surrounding Detroit. Some 98 per cent of the lots in the 1938 Tax Sale, covering these townships (not including the cities), were vacant. Michigan Planning Commission, *Subdivision Development in the Detroit Metropolitan Area* (Lansing, Michigan, June 1939), p. 31. The development of these areas is greatly hampered by confused titles.

for the use of the property tax by state governments. In certain instances, the interest of the state government in property-tax administration has resulted in high-caliber administration, especially in the (assessment-tax rate) equalization field. Such beneficial results can, however, be retained if the states established flexible administrative controls over property-tax administration.

Because of the heavy local service responsibilities, many communities have turned to an increasing use of business and transaction taxes, as well as to special service charges. Today, localities employ gross-receipt business licenses, flat-rate licenses, occupational taxes, gross receipts and franchise taxes on utilities, license fees on meters and telephones, sales, poll, and gasoline taxes, motor-vehicle licenses, inspection and highway privilege fees. While certain of the charges and licenses can readily be justified on the basis of direct benefits granted by the governments, the tendency of localities to reach out for whatever revenue sources are at hand has serious shortcomings. The taxes employed are almost invariably of a regressive and repressive nature and tend to complicate the revenue system unduly.

It would be highly desirable if for this economically unsound and chaotic mass of taxes there were substituted an improved and stabilized system of local sharing of certain state-collected taxes. Because of the desirability of placing local revenues on as stable a base as possible, it seems advisable that the states share with their localities a certain percentage of their yields from gasoline and automobile taxes and licenses. At the present time, local governments spend large sums on highways and streets, on providing adequate traffic control and furnishing proper street lighting;³⁴ yet they received little—in many cases nothing—from automobile and gasoline taxes. In addition to the need of localities for a productive revenue source beyond the property tax, a good case can be made for the localities to receive a substantial share of gasoline and automobile taxes because of the costs imposed upon communities through the widespread use of the automobile. This important revenue source cannot be tapped locally, chiefly because of state restrictions and because of administrative difficulties. Under such circumstances, it is logical that the state collect the revenue and then return a proper share to the localities.

³⁴ In the fiscal year 1941, local government expenditures for highways and streets amounted to \$467 million.

Appendix A

MOULTON'S "THE NEW PHILOSOPHY OF PUBLIC DEBT"

*A Reply by ALVIN H. HANSEN*¹

ANYONE familiar with my articles and books will, I think, recognize that Moulton's book presents a distorted picture of my views. I believe, however, that the general reader is not interested in personal controversy but *is* interested in the real issues at stake. These issues are so important from the standpoint of national interest and the future of the American economy that clarification is urgently needed.

Mr. Moulton uses the phrases "continuous expansion of the public debt" and "permanent deficit financing" to describe the so-called new philosophy of public debt. In my article in *Fortune*, November, 1942, I said emphatically: "There are certain conditions under which a reduction of the public debt becomes imperative." A *continuous* expansion of the public debt, regardless of the prevailing economic conditions, would be a completely irresponsible policy for any government to follow in its fiscal program.

What I do hold is that it is sound fiscal policy to control public expenditures, taxation, and borrowing so as to promote economic stability at continuously high levels of business activity and full employment. A sound fiscal program involves curtailment and restraint at times in order to prevent inflation and, at other times, it involves an expansionist program in order to prevent deflation and mass unemployment.

In my pamphlet *After the War—Full Employment*² I said:

Whether taxes should equal, fall short of, or exceed expenditures must be decided according to economic conditions. . . . When is it desirable to pay off part of the debt? Certainly not when there is danger of an impending

¹ A part of this Appendix appeared in an article in *Finance* on July 10, 1943, and is here reproduced by permission of the editor.

² National Resources Planning Board, *After the War—Full Employment*, Revised, February 1943, p. 7.

depression. Under certain conditions it would be desirable to do so. Under other conditions it would be quite unsound policy to retire the debt. Financial responsibility requires a fiscal policy (including governmental expenditures, loans, and taxes) designed to promote economic stability. It would be quite irresponsible to cut expenditures, increase taxes, and reduce the public debt in a period when the effect of such a policy would be to cause a drastic fall in the national income. Equally, it would be financially irresponsible to raise expenditures, lower taxes, and increase the public debt when there is a tendency toward an inflationary boom.

Here is a clear statement of the aim of rational fiscal policy. This quotation (and many others like it) Mr. Moulton does not give in his book.

Mr. Moulton himself presents two conditions under which the national debt may be permitted to rise from the long run standpoint. Thus under given conditions Moulton himself is not averse to a secular rise in the public debt. With one of these conditions I agree, but with the other (at any rate as he states it) I most seriously disagree. He says, first, that the debt may rise if the loan is used to finance self-liquidating public works. With this statement I heartily concur so far as it goes. Mr. Moulton adds that a gradual expansion of the public debt is permissible "at a time when, in consequence of private business expansion, the national income is steadily rising. . . ." In discussing the reasonable limits of the public debt, I have frequently stated that one thing which one must consider is the ratio of debt to the national income. But I certainly do not agree that it is desirable to increase the public debt if the national income is rising in consequence of a great private-investment boom. It is exactly in such a situation that restraint should be exercised in public expenditures in order to counter inflationary tendencies. It is precisely when a strong private-investment boom is going on that it is sound public policy to reduce the public debt.

What is true is that if we pursue an expansionist fiscal policy which will insure full employment, we have every right to expect the national income to rise from decade to decade as a result of increasing productivity due to technological progress. The use of public credit (under conditions which are likely to prevail once the stimulating effects of the war have passed) will not unlikely contribute substantially to this result. With a rising national income one need not fear a proportional

rise in the public debt. The ratio of income to debt, I hold, is *one* of the factors on the basis of which one may judge, within broad limits, the permissible increase in the public debt. But one would certainly not promote economic stability by permitting a large increase in the public debt when a vigorous private-business expansion was going on. Mr. Moulton's criterion for a permissible expansion of the public debt is a highly dangerous one and is an indication that he has never grasped the essence of rational fiscal policy, namely, the *control* of expenditures, taxation, and borrowing so as to promote *stability*.

At another point in his volume, Mr. Moulton argues "that in times of depression and readjustment, public outlays not covered by taxes may be both essential and helpful in stimulating recovery." Here he adds that in prosperity periods "the budget should provide a surplus with which to reduce the public debt." With this I agree, assuming that prosperity has indeed reached such full utilization of resources that inflationary tendencies threaten to upset stability.

It seems to me that a fair reading of Moulton's book as a whole leads to the conclusion that, on balance, he is more interested in the retirement of public debt than he is in the pursuit of a fiscal policy which will produce economic stability at full employment. The latter policy may or may not permit of retirement of the public debt. This is precisely the issue: does one adhere to the dogma that public debt must be retired, or is one willing to abandon this dogma and to follow a fiscal policy which will promote economic stability at full employment? Here is the essence of the whole controversy.

At this point I think it is important to point out that an expansionist fiscal program involves fundamentally an increase in public expenditures financed from nonregressive taxation or from borrowing or some combination of these two financing methods. As I have repeatedly stated, *it is not true that an expansionist fiscal policy necessarily means deficit financing*. What is true is that the expansionist effect of expenditures is likely to be greater if some considerable part is financed from borrowing than would be the case if it is all financed from taxation. But it is important and necessary to point out that an expansionist fiscal policy is not limited to a program of deficit financing. I do hold that it is frequently desirable to finance an expansionist program by borrowing. *From the long-run standpoint, this may involve an increase in the debt* (always remembering that the national income will also

rise, as it must or else in view of technical progress, we should experience ever-increasing unemployment).

For some time after the war, restraint and not expansion will be called for. But once the stimulating effect of accumulated deferred demand incident to the war is over, it may well prove to be wise and sound policy to finance some part of a long-run expansionist program by borrowing and not to rely wholly upon taxation. For one thing, I have pointed out that life-insurance companies, savings banks, and individuals who wish to buy government savings bonds may well wish to put several billion dollars of savings into government bonds each year. I see no reason why (assuming that an expansionist program is called for) new issues should not be offered to satisfy this more or less persistent demand for investment in government bonds. This does not mean, however, a deficit every year. The extent of borrowing would vary with the cycle, and if strong boom years develop, the debt should be reduced; but from decade to decade the persistent demand for government issues could be satisfied by an increase in the public debt. This, I repeat, could well take place without any rise in the debt in relation to the national income. We have a right to assume, I think, an increase in the national income as productivity increases, at the rate of 3 per cent per annum. The compound rate of increase was in fact about 3 per cent from 1929 to 1942.

With respect to the public debt, Mr. Moulton agrees, I believe, that its fundamental significance lies in the effect of the debt upon the distribution of the national income. Put concretely, this means that the really significant thing about a public debt is how the ownership of bonds is distributed, on the one side, and from what groups and economic classes the taxes are collected. This is precisely my own view. A public debt held only by the rich, while taxes are levied only on the poor, would have a serious effect upon the workability of the economy, particularly in a society such as ours which needs to emphasize and to encourage consumption expenditures. I have tried to point out in my writing that the ownership of government bonds is in fact widely distributed, partly through mass holdings and partly through savings institutions, such as savings banks, life-insurance companies and the public trust funds, as well as through the commercial banks which perform a useful and highly necessary service for the entire community and whose costs must be covered by adequate earnings. On the

other side, our present tax structure is highly progressive. I do not, therefore, believe that our public debt has a seriously adverse effect on the distribution of income.

Nevertheless, Mr. Moulton believes that the public debt that we shall have at the end of the war must be regarded as a serious evil and that we should bend every effort to reduce it. This I regard as an extremely dangerous dogma which, if rigorously pursued, would have most unfortunate economic consequences. Again I repeat that whether we should reduce the debt or not depends upon the economic circumstances. Mr. Moulton persists in scaring the public with the belief that a public debt is a serious menace. Quite the contrary, I hold that a public debt properly distributed and with a sound tax structure can in fact turn out to be a genuine economic benefit for reasons which I shall point out in a moment. I hasten to add that it does not follow that a debt, say ten times the debt we shall have at the end of the war, would equally be a good thing. In economic matters, proportion and balance are of the utmost importance. This view, as I said in my *Fiscal Policy and Business Cycles*, was well stated by Alexander Hamilton, and it is of interest to note that he made this statement precisely in answer to his opponents who imputed to him the view that public debts are public benefits under all conditions. To this Hamilton replied that "it interests the public councils to estimate every object as it truly is; to appreciate how far the good in any measure is compensated by the ill, or the ill by the good. either of them is seldom unmixed."³

As I have said elsewhere in my writings, "one must never lose sight of balance in economic life. It may be a good thing, under certain circumstances, to lower the price of steel by 10 per cent, but it does not follow that it must be good economic policy to force a reduction by say 90 per cent." It does not follow, merely because a given public debt properly distributed may in fact prove beneficial to the economy as a whole, that there are therefore no limits to how far one should go in increasing the public debt. Similarly as to private debt, it does not follow that because some private debt is necessary an unlimited amount would be desirable.

What I would contend is that we shall in fact enjoy certain positive benefits from the public debt as distributed at the end of the war. There will also be disadvantages. One must weigh the good against

³ See my *Fiscal Policy and Business Cycles*, p. 166.

the ill effects. Mr. Winston Churchill, in his recent speech on postwar problems in England, spoke with confidence and hope of the fact that the common man in England will own two or three hundred pounds of government bonds after the war. A wide mass holding of bonds provides security for the individual in times of distress. It offers a safeguard to the economy as a whole against extreme depression, since it provides the masses with potential purchasing power. It, moreover, gives the mass of the population a stake in the social structure, which tends to promote stability in the social order. A large public debt held by the mass of the population as a nest egg of saving is, I hold, definitely a good thing. I repeat that it is possible to abuse any good policy and to go to irrational extremes, but with respect to the magnitude of the public debt, enlightened and rational fiscal principles are at hand to determine what we may or may not wisely do.

A public debt widely owned by the mass of the population amounts in effect to a kind of national insurance system to which most of us contribute (more or less in proportion to our abilities) through the payment of taxes, in order to service the interest on the debt; and from this insurance pool most of us receive benefits (according to the distribution of bond holdings) in the form of interest receipts. But the really essential part of this insurance system is that the owner of the bond can, in time of distress, sell it or use it as collateral in borrowing from the banks in order to meet unforeseen contingencies. A wide distribution of government bonds may well prove, in the years ahead, an important safeguard against serious economic depression. If this is so, as I firmly believe it is, is it reasonable or sensible to take the position that the public debt at the end of the war must be regarded as a serious economic evil? I do not think so. The real question is: are we adults or are we timid children, afraid to use the fiscal instruments at hand for the common good, in a manner capable of promoting economic stability and economic progress?

It cannot be stressed too strongly that the view that a debt is inherently bad is likely to force us to follow policies which, under certain circumstances, cannot fail to prove completely ruinous. The dogma that we must cut expenditures to the bone and rigorously retire the public debt is often put forward as a program of "sound finance." (In fairness I hasten to add that Moulton does not hold this extreme view but, on balance, his emphasis points in this direction.) Far from being sound

finance, however, such a policy amounts to utter financial irresponsibility. I repeat that it is equally financially irresponsible, in periods when inflationary tendencies are present, to engage in large public expenditures and to increase the public debt.

There is no probability, in my judgment, that the goal of economic stability (including stability in the cost of living) with continuous high levels of income and full employment can be achieved without a flexible adjustment of public expenditures, taxes, and borrowing. This is the essence of a rational fiscal policy. Much of my writing in recent years has been done under the shadow of serious depression and unemployment. I have thus stressed, and rightly so, expansionist fiscal policy. For some years to come, the war and its aftermath will bring us wholly new conditions. It may well be that under these new conditions we shall for some time have to fight inflation more than deflation. The fiscal policy which I have advocated is prepared to meet inflation no less than deflation. In a period of depression and unemployment, loan expenditures, involving deficit financing, may well be desirable. If, on the other hand, inflation needs to be checked, then public expenditures should be sharply curtailed, taxes should be increased, and the public debt can thus be reduced.

A major problem confronting all advanced countries is that of maintaining continuously high levels of income and full employment. In order to achieve this end, it will be necessary, I think (once the stimulating effects of the war have spent their force) to pursue a bold and vigorous fiscal policy. In our own country, as in most advanced countries, there is a wide field for useful and productive public expenditures without encroaching upon the accepted traditional sphere of private enterprise. These include public-investment aspects of urban redevelopment, transportation facilities, river-valley development, flood control, soil conservation, reforestation, rural electrification, slum clearance and low-cost housing, international investment projects such as those now being made by the Export-Import in Latin America, and finally a social-security and public-welfare program including equal educational opportunities, child welfare, public health, nutrition, and an extension of our system of social insurance. Public resource development projects not only raise the productivity and standard of living of the areas in which they are made, but also open up private-investment outlets. Moreover, social-welfare expenditures act like an irrigation

system, distributing purchasing power widely over the whole country, thereby raising the level of consumption expenditures and business activity.

In order to pursue a rational fiscal policy, any government administration must determine how far we can go with public expenditures in view of the limitation of productive resources without producing an inflation, and, on the other side, how far we *must* go in order to sustain a level of effective demand adequate to provide full employment. The goal of fiscal policy is to achieve substantially full employment without carrying the expansion to the point of inflation. This goal cannot be realized with 100 per cent perfection, but it is the goal that every modern democracy must strive to achieve. How much can be spent without producing an inflation (and, on the other side, how much must be spent to produce full employment) will depend partly on how the expenditures are financed (whether from taxes or from borrowing). The more that is financed from taxes, the larger the public expenditures can be without producing an inflation. It follows from this statement, be it noted, that if the expenditures are financed entirely from taxes, it will require larger expenditures to produce full employment. Here one encounters, therefore, *one* of the criteria on which one must decide how much should be tax financed and how much loan financed. Inflationary tendencies will, moreover, be reached sooner if expenditures are financed by borrowing from banks than if financed by borrowing from the savings of the public. A sound fiscal program requires that close attention be paid to the kind of expenditures that are made, choosing those that are most useful in raising the standard of living and increasing the productivity of our natural and human resources. It requires, also, that particular attention be paid to the kinds of taxes employed and the degree to which the budget can wisely be covered by taxation. If borrowing is employed, it requires, moreover, close attention to the appropriate source from which funds are derived. All of these will vary according to economic circumstances and according to the various phases of the business cycle.

It is apparent from what is said above that no simple statement can be made about a sound and rational fiscal program. Any statement such as that made by Mr. Moulton in his recent book which pretends to describe modern views with respect to fiscal policy under such phrases as "continuous deficit financing" or "permanent increase in

the public debt" is pure nonsense. The public issues involved are too serious to permit inaccurate statements of this character. The problems involved are of the greatest significance for the future welfare of our country and they deserve careful and thorough study and analysis not only by public officials and business leaders but by the general public.

Quotations from books and articles by Alvin H. Hansen on the public debt which are not taken account of in Moulton's volume.

1. *The Public Debt as a Balancing and Stabilizing Mechanism*

1. "Fiscal policy therefore must be used primarily for the purpose of maintaining a balanced economy. This may or may not mean a balanced budget." (*Harper's*, April 1942, p. 499)
2. "Fiscal policy, which directs the use of expenditure, debt, and taxation, is a powerful prime mover, and, like other great forces such as electricity, it must be subjected to control. It is not and should not be the main motive force of the economy, but rather a balancing factor, and sometimes it must be used as a brake rather than as a stimulant. Prudently managed, it may produce great benefits, ignorantly or recklessly employed, it may wreak great damage." (*Harper's*, April 1942, p. 491)
3. "There are certain conditions under which a reduction of the public debt becomes imperative. Likewise there are circumstances that call with equal urgency for an increase. A reduction is necessary in the event of a cumulative boom that threatens to provoke price inflation; that is, when the effective purchasing power in the hands of the public begins to outrun the total amount of goods and services for sale. By a sharp reduction in government expenditures and an increase in taxes, inflationary tendencies can be stopped. The taxes sop up that part of the purchasing power in the hands of the public that would otherwise be used to bid up the prices of goods and services, while a reduction in government expenditures curtails the income flow.

"But a complete reversal of this procedure is called for when depression threatens. For an increase in the debt resulting from expenditures in excess of revenues from taxation will add to real income and employment when the purchasing power in the hands of the public is short of the total of goods and services that could readily be produced for sale.

"It becomes clear, then, that if the over-all total of the debt in rela-

tion to the national income is manageable, it may be raised or lowered, as a part of the operation of a co-ordinated fiscal policy in conjunction with a flexible program of public investment, sufficiently to keep the economy at all times on an even keel. This would be a compensatory fiscal policy—the policy we must pursue if we would make in the future any determined effort to avoid the evils and dangers of depression and unemployment and the periodic waste of our productive resources" (*Fortune*, November 1942, p. 172)

- 4 "If this analysis is sound, it points to the conclusion that the public debt, taxes, and changes in the money supply are all part of a balancing mechanism. How much reliance should be placed on each as a means of financing government expenditures depends upon a variety of considerations. It involves judgments with respect to the adequacy of the means of payment, adequate liquidity, the importance under certain conditions of using relatively expansionist and less restrictive methods of financing, the appropriate (socially desirable) degree of inequality of wealth and income, the relative desirability of tapping savings streams through borrowing (increasing the public debt) or through taxation." (*Fiscal Policy and Business Cycles*, p. 184)

II *Debt and Inflation*

1. "A too rapid *increase* in debt, particularly when it is accompanied by a rapid increase in bank credit, will produce an inflation." (*Fiscal Policy and Business Cycles*, p. 173)
2. "Expansion should, of course, always be restricted to the point of reasonably full employment in order to prevent price inflation. In the event, however, that huge governmental expenditures *must* be made (as in wartime), taxation serves a further purpose. Diversion of resources from private consumption to war outlays becomes absolutely necessary, at least when the economy approaches full employment. If this diversion is not achieved, if the war expenditures are piled on top of private expenditures, inflation of commodity prices will inevitably follow. Taxation is a powerful device to achieve this diversion of resources. And this is especially true of taxes which weigh heavily on private consumption." (*Fiscal Policy and Business Cycles*, pp. 179-180)
3. "But public policy must be used equally boldly to prevent inflation from gobbling up an increased flow of income without the attainment of full employment. In other words, whenever for any

reason the effective purchasing power in the country begins to exceed the total of goods and services which the economic system can produce, a sufficient part of such purchasing power must be diverted and used to retire public debt, thus making it possible to maintain a substantially stable price level." (*Harper's*, April 1942, p. 499)

4. "This brings us to an aspect of the entire process that might if ignorantly or recklessly managed upset the apple cart very thoroughly indeed. The commercial banking system stands in a sort of key position in the whole scheme of things financial. It is potent in the same manner as fiscal policy, to which it may become an important adjunct, and in like manner it must be used with knowledge and skill. It can increase, instantly and enormously, the amount of credit outstanding in the country (which is the same thing as the amount of money) in a fashion that seems magical. It can do so by making ordinary business loans, but it can accomplish precisely the same result by buying government bonds. It does so when it pays for the bonds, not with money actually in existence, but by mere entries in its books—when it credits the government with the amounts involved, in the form of deposits against which checks can be drawn at once. And here is the point at which government debt, if uncontrolled, might become the principal cause of the sequence of events leading to inflation." (*Harper's*, April 1942, p. 493.)
5. "If the demand is sufficiently general and prolonged the result is likely to be a degree of economic activity that would warrant fiscal measures to prevent inflation. And such measures (increased taxation) would in turn actually reduce the amount of government debt outstanding by producing budgetary surpluses with which to retire part of it." (*Harper's*, April 1942, p. 493.)

III. *Limits to the Public Debt*

1. "What has been said with respect to inflation and distribution of wealth and income implies that there are limits to the public debt which, if exceeded, will tend to affect the workability of the economy. But these limits must be conceived of, not in terms of a fixed amount or a static situation, but in terms of a dynamic process. Account must be taken of rates of change and the magnitude of the public debt in relation to other magnitudes, especially the ratio of debt to national income. With respect to rates of change, a too rapid increase in loan expenditures at full employment will produce inflation." (*Fiscal Policy and Business Cycles*, p. 174.)

2. "Much of the discussion about the limits of the public debt is wholly unrealistic. There are no rigid and fixed limits. The problem is a manageable one, and can best be taken care of by ensuring that taxation is adequate. (1) to prevent inflation and (2) to provide a reasonably equitable and workable distribution of wealth and income. Within the limits set by these criteria, it is possible to determine, according to varying circumstances, what proportion of public expenditures may advantageously be loan financed and what proportion should be tax-financed." (*Fiscal Policy and Business Cycles*, p. 175)
3. "Safe limits will be determined primarily by the level of the national income. Other governing factors are the kind of taxation levied to service the debt and the manner in which it is distributed among the various kinds of bondholders—and, of course, the wisdom of the public investment and public expenditures made. But the all-important factor is the level—the sustained level—of the national income. If this is substantially as high as is possible when all our human and material resources are employed, the other factors can be kept under control." (*Fortune*, November 1942, p. 175)
4. ". . . that there is no unavoidable danger in public debt so long as it is held to a reasonable ratio with the national income, that a reasonable ratio would permit a debt far larger than any we are likely to see, notwithstanding the enormous cost of the war and such additional borrowing as may be necessary afterward to make sure of full utilization of our material and human resources" (*Harper's*, April 1942, p. 500)

IV. *Expansionist Fiscal Policy Is Not Necessarily "Deficit Financing"*

1. "Governmental expenditures may, however, be income-stimulating without being loan financed. It is true, as just noted, that if the expenditures are financed from consumption taxes, the effect is obviously merely to divert resources without increasing the total income flow.⁴ But if financed from progressive taxation, thereby tap-

⁴ This statement is true if the taxes are imposed *first*, thereby curtailing the flow of private consumption expenditures. If, however, the *initial* new government expenditures are loan financed, private consumption expenditures will not be reduced. Out of the enlarged inflow flow, generated by private plus public expenditures, the new services provided by the government may (after the initial expenditure) be tax financed, leaving the former flow of private consumption expenditures unaffected. Thus the net increase in income is retained despite the fact that loan financing stops.

ping a stream of savings which might not have found outlet in productive activity, adequate expenditures may be expected to drive the national income by a cumulative process up to the full-income and full-employment level. At first, while the national income was still rising, the expenditures might be largely loan-financed. But after the national income had approached full employment levels, a sharply progressive tax structure would then draw in an amount of taxes sufficiently large to balance the budget, including both operating and capital expenditures." (*Fiscal Policy and Business Cycles*, pp. 182-183)

2. "Let there be no misunderstanding. This is not an argument for continuous loan expenditures for their own sake (commonly called 'deficit spending,' the term being used sometimes by opponents of compensatory fiscal policy to arouse emotional reactions against it). In all probability there will be times when governmental expenditures, however large, can and should be made entirely by means of taxation." (*Fortune*, November 1942, pp. 172-175)

V. *Public Debt, Property Ownership, and a Stake in the Social Order*

1. "Life insurance, savings banks and other thrift institutions, baby bonds, and social security trust funds have taken in recent years annually about \$3 billions of government issues. Institutional thrift streams rightly seek, wholly or in large measure, the safest type of security: namely, government bonds. A wide diffusion of property ownership is thereby encouraged. There is thus a solid basis in these thrift streams for controlled borrowing." (*Fiscal Policy and Business Cycles*, p. 179.)
2. "The attack on chronic unemployment by means of public expenditures financed by a continually rising public debt is essentially a conservative⁸ proposal. This is true in the respect that it does not necessarily involve a redistribution of income unfavorable to property owners. Indeed, as we have noted, too great a reliance on borrowing could easily lead to an undue concentration of wealth. This would especially be the case if the interest (and amortization charges

⁸ Note that the word "conservative" is here used in the sense of protecting property rights rather than in the sense of sound government finance. It refers to the effect of borrowing, as opposed to taxation, on the distribution of wealth and income. Torn from its context it acquires just the meaning that Moulton pins on me, but which is clearly something entirely different from the meaning it has when read as a part of the whole paragraph. This quotation, torn from its context, as printed in Moulton's book, distorts the argument.

in the case of capital projects) were covered in large part by regressive taxation." (*Fiscal Policy and Business Cycles*, p. 181.)

3. "A limited increase in the public debt tends to promote a wide distribution of property in so far as the new issues are purchased by thrift institutions. On the other hand, a very rapid increase in the public debt necessarily implies a relatively light tax burden on upper-income groups and on corporations, tending to promote concentration of wealth and income. It is considerations such as these that one must bear in mind when one seeks to appraise the role of public debt and to determine how rapidly it may be permitted to rise." (*Fiscal Policy and Business Cycles*, pp. 184-185)
4. "We must not conclude, however, that the public debt has no influence whatever upon the economy. In point of fact, one of the most important single effects is on the distribution of wealth and income." (*Harper's*, April 1942, p. 497)

VI. *Fiscal Policy Must Be Exercised with Care and Restraint, and with a Sense of Social Responsibility*

1. "Clearly fiscal policy is now and will continue to be a powerful factor in the functioning of the modern free enterprise economy. It must be used with a high sense of social responsibility and it must be administered by experts. At the same time the entire procedure must be kept under the control of Congress; else our democracy would go by the board." (*Harper's*, April 1942, p. 500.)
2. ". . . fiscal policy—public expenditure, debt, and taxation—can in fact be successfully used to achieve full utilization of resources without destroying the essentials of our system of free enterprise; but only if it is handled with the requisite degree of knowledge and skill. . . ." (*Harper's*, April 1942, p. 500)

Appendix B

RECOMMENDATIONS OF THE ROYAL COMMISSION ON DOMINION PROVINCIAL RELATIONS IN CANADA ¹

IN 1937, a Royal Commission was set up in Canada to study the financial relations between the Dominion and the provinces.

In the interval from 1867 (the date of the British North American Act) to 1937, several major economic changes occurred. Social-welfare and social-service expenditures grew rapidly, especially in the great depression of the thirties. Provincial and local revenues were quite inadequate to discharge properly the functions assigned by the constitution. As a consequence of the first World War, the Dominion had entered the field of direct taxation, especially income taxation, in competition with the provinces.

The problems and difficulties of the provinces were brought to a climax by the relief load incident to the depression and by the differential impact of the depression on the financial position of the various provinces. The fall in export prices, the tariff policy pursued by the Canadian government, the monetary policy followed since the thirties had a profound impact on the economic position of the various provinces and made the need for certain changes in the Dominion-Provincial relations urgent. The Dominion government after 1930 was compelled to assume an increasing proportion of the cost of unemployment and to contribute the major part of the expenditures for old-age pensions. It granted loans to four western provinces to enable them to meet their maturing debt obligations. In some cases the Dominion government assumed certain contingent and direct liabilities of some of the provinces.

By 1937, nearly half of all the public expenditures were made by the Dominion government. The Dominion functions included national defense, the provision and maintenance of the transportation system,

¹ Cf. *Report of the Royal Commission on Dominion-Provincial Relations*, Ottawa, 1940, particularly Book II, Recommendations.

particularly railways and waterways, the legislative, judicial, and general administration, and almost half of the relief and public-welfare expenditures. The provinces and municipalities were providing for increased costs of transportation, mainly streets and roads, but their major increase in expenditures was in the public-welfare field.

On the revenue side, the Dominion government levied customs, excises, manufacturers' taxes, and about half of the liquor taxes. The taxation on real estate and property in general was the main source of revenue of the municipalities, while gasoline and automobile license taxes were exclusively reserved to the provinces. Some of the provinces had introduced heavy sales taxes and even a tax on wages. Both the Dominion government and most of the provinces levied personal income taxes and corporation taxes.

The recommendations of the Commission were intended to relieve the provinces of the burden of unemployment relief, to restore the credit of the provinces which had suffered heavily during the depression, in some cases approaching a state of insolvency, to achieve a better distribution between functions and revenues in general, and to provide grants designed to restore to a reasonably equitable basis the differential financial position in which the various provinces would find themselves after the recommended adjustments had been made.

The Commission recommended the assumption by the Dominion of unemployment relief for employable workers, and the introduction of a national system of compulsory unemployment insurance. The residual social-welfare functions, such as the support of the unemployables, payment of widows' pensions and mothers' allowances, child welfare, public health, health insurance, workmen's compensation, and the support for education, were to remain the exclusive responsibility of the provinces.

On the revenue side, the Commission recommended that the provinces renounce the levying of personal income taxes, corporation taxes, and succession duties, thereby reserving those revenue sources exclusively to the Dominion government. In the case of the taxation of incomes derived from the depletion of irreplaceable natural wealth, the Commission recommended that a part should be refunded to the provinces. The provinces were offered the exclusive use of the gasoline and automobile taxes, the revenue from liquor control, and revenues

from the public domain. They could, moreover, continue to levy license fees, real-estate taxes, and consumption taxes.

In order to support and restore provincial credit, the Commission recommended that the Dominion government should assume all the provincial debts.² On the other hand, the provinces would be required to pay over to the Dominion the earnings on any productive projects financed by bonds assumed by the Dominion.

The Dominion, on its side, was to gain, as we have noted, in being granted exclusive control over certain tax sources, and by being relieved of the old unconditional subsidies to the provinces. These subsidies, introduced in 1867, had become increasingly distorted as a consequence of political considerations and political pressure.

These recommendations, it was recognized, would affect unequally the position of the various provinces. The Commission therefore suggested the introduction of "national adjustment grants" to balance the revenues and expenditures of the provincial governments. The national adjustment grant for each province would be determined on the basis of (a) the expenditures needed to finance developmental projects and to provide social services according to the "normal Canadian standard," and (b) the yield of provincial taxation of normal severity. An attempt would be made to compute, province by province, the amount, if any, which "each individual province should receive from the Dominion annually to enable it to provide normal Canadian services with no more than normal Canadian taxation"³

In its recommendations with respect to grants, the Commission took cognizance of the unsatisfactory experience in Canada with conditional grants, due mainly to the lack of an adequate system of administrative supervision. On the other side, it was not deemed desirable or feasible to recommend joint Dominion-Provincial administration.

The national adjustment grants were to be subject to review every five years and the Commission recommended the establishment of a Finance Commission which would advise the Dominion on this matter. This Commission would also be the agency supervising provincial

² Dominion assumption of provincial debt would also lead to a reduction of interest charges since the Dominion could borrow at more favorable rates.

³ *Report of the Royal Commission on Dominion-Provincial Relations*, Book II, *op. cit.*, p. 272.

credit. If the provinces wished to borrow in the future, they could do so in two ways: (*a*) borrow on their own credit independently, in which case the service charges would not be considered in determining the amount of the adjustment grants, and (*b*) submit their borrowing plans to the approval of the Finance Commission.

Since the municipalities were considered organs of the provinces and thus the exclusive concern of the latter, the recommendations of the Commission did not include suggestions with regard to their financial problems. It was, however, felt that the recommendations which had been made would afford opportunity to the provinces to make adjustments which would improve the financial position of the municipalities.

The financial recommendations of the Commission are, to a considerable extent, analogous to the provisions of the British North American Act of 1867. The chief taxing power would still be left with the Dominion, and indeed it would be given the exclusive right of levying personal and corporate income taxes. The Dominion would once again assume the provincial debts. The earlier unconditional subsidies would be replaced by national adjustment grants which, although different in character, would meet present-day problems by methods not unlike those which served to make reasonably workable inter-regional adjustments in the early period of federation.

Appendix C

STATE LEGISLATION NEEDED FOR URBAN REDEVELOPMENT

By ALFRED BETTMAN

FEDERAL legislation can provide for the organization and powers of the federal agencies which are to participate in urban redevelopment and for the application of federal funds for purposes connected with urban development; but all the powers of the municipalities or local public agencies to receive and apply the federal aid and to carry on the development have to be derived from state legislation. As existing state legislation is universally inadequate for these purposes, no federal legislation can be effective until and unless adequate state legislation is enacted in the various states. Unless the federal and state legislation are geared into each other, both will be ineffective.

In urban development and redevelopment, three types of functional official activity are necessarily involved, namely planning, legislation and administration. Planning includes (a) the master or general planning of the territory of the city or metropolitan urban area, and (b) the more precise planning of the various districts or areas. Legislation includes the acts of local legislative organs in giving local sanction to plans as the basis for the use of public money, the acquisition of land, lease, sale or other disposition of the land. Administration includes the actual carrying out of the approved plans by the actual acquisition of the land and the disposition thereof in accordance with the legislative authorizations.

Consequently the essential state enabling legislation may be summarized as follows:

1. The establishment, organization and powers of planning agencies. (To some extent legislation on this subject exists in most states, but for the great task of the replanning of the cities and urban areas, a review of this legislation will indicate a greater or less degree of inadequacy. State legislation should include the size, method of selection, compensation, staff, work procedure and general powers of the municipi-

pal planning agency. There might be alternative provisions for different forms of planning agency)

2. The establishment, composition, and organization of metropolitan planning commissions. (While the planning agency of the central city could be given the power to include the whole urban area in its master plan, comprehensive state legislation should provide for the possibility of metropolitan planning agencies, representing in some way the people of the entire area)

3 The authorization of planning agencies to make master plans; specifying the master plan as the essential step in the exercise of all the powers granted for carrying out the urban development or redevelopment, describing in general the minimum content of a master plan, including the marking out of the recommended locations and extents of the areas to be developed or redeveloped; describing the minimum content of the detailed plan of the development or redevelopment area; and requiring the approval of these plans by the local legislative body.

4. A general grant of power to municipalities and the instruments thereof to bring about a development or redevelopment or reconditioning of its territory and the areas thereof, and for that objective to acquire real property, by purchase or eminent domain, all in accordance with the procedures, conditions and other provisions set forth in the statute (Presumably existing legislation provides for procedure in the acquisition of property by eminent domain, but if the existing statutory procedure is deemed unsatisfactory, the statute under discussion could be made the vehicle for an improved eminent-domain procedure.)

5. Authorization of the transfer to appropriate public bodies of all those pieces of real property which, in accordance with the project area development plan, are to be devoted to streets and other public uses, excepting public housing.

6. Authorization of the leasing of all the remainder of the development area; that is, all of the area which is to be devoted to private uses or to public housing, to development or redevelopment corporations or to public-housing authorities, including a statement of the required conditions in any such lease and particularly the requirement that the lessee and its successors shall carry out the approved development plans. (Provision for leasing the areas without any provision for

selling them would constitute the adoption of the lease land policy by the state legislature. If the choice between the two methods is to be left to the local legislative bodies, then the state statute would contain authorization of selling as well as leasing, the specification of required conditions of sale, the chief of which would be that the purchaser shall carry out the approved plan.)

7. Authorization for the creation of development or redevelopment corporations with a general grant of powers to become the lessee or purchaser of a redevelopment or development area, together with a greater or less degree of specification of limitations upon such corporations with respect to such matters as capital and financial structure, dividends, and public regulation of the operations of the corporation.

8. The grant of authority to the municipalities to accept federal or state aid, and comply with the terms and conditions of such aid.

9. Provisions requiring the rentals from the leased areas and the proceeds of sale from the sold areas to be applied to the repayment of the federal aid or the state aid or other source of the original financing of the land acquisition, which may include the requirement that all such rentals, revenues and proceeds from all the areas shall be pooled and the pool applied to the payment of all the obligations incurred for all of the areas.

10. Authorization for the issuance of general credit bonds for land acquisition, including land to be devoted to private uses. (This should be embodied in the statute if it is desired not to restrict the repayment of the capital outlays on the land acquisition to the revenues, rentals and sales proceeds of and from the acquired land.)

11. The declaration that the acquisition or assembly of real property and the holding or leasing or sale thereof for development pursuant to master and area development plans, is a public use for which eminent domain may be exercised.

12. Declaration with respect to tax exemption. (Either provide for such exemption as is to be allowed on development or redevelopment projects; or else for expressly excluding any tax exemption beyond that which is already provided for in the existing statutes such as the statutes relating to public housing.)

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